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VOL. 59 JUNE, 1935 No. 6

EDITORIAL

The Legislative Mills

In the April issue of THE JOURNAL OF ACCOUNTANCY we drew attention to the great number of bills introduced in state legislatures during the past winter for the purpose of effecting changes in the C. P. A. laws of the various states. We have now received some statistical information which makes it possible to amplify the earlier notes. We are advised that thirty-six accountancy bills have been introduced in the legislatures of twenty-four states and one territory during this year. Of these, twenty-three were considered by the committee on state legislation of the American Institute of Accountants to be objectionable. Five of them provided for waiver of examination, three for oral examinations, eleven were of the so-called two-class restrictive character, two would prohibit practice under an assumed name, two would restrict practice by licence without provision for C. P. A. certificates, eleven provided for administrative changes or new laws of more or less standard type and two other bills are said to have been introduced but particulars are lacking. Out of this mass of legislative effort, two bills have been passed. One, an administrative bill, in Georgia and one in Montana, granting waiver certificates. Ten bills are still pending, one of which provides for waiver certificates, four are of the two-class sort, one would prohibit the use of an assumed name and four are administrative. One of the most important of the legislative efforts was New York assembly bill 2377. This was a bill of the two-class kind with various novelties which did not meet with the approval of the New York State Society of Certified Public Accountants. It was defeated three times but on the last occasion was reconsidered and passed. It then went to the governor who placed his veto upon it. In explanation of his action, Governor Lehman said:

"The education law now prescribes certain requirements for qualification as a certified public accountant. It forbids anyone to use the description 'certified public accountant' or the abbreviation 'C. P. A.' unless he is a certified public accountant under the law of the state. This bill, in effect, creates a new class of accountants to be known as public accountants. An appropriate certificate as a public accountant could be obtained from the board of regents upon satisfying qualifications, less rigid and less exacting than those imposed upon certified public accountants. This new class of accountants would be permitted under the law to advertise themselves as public accountants and use the abbreviation 'P. A.' This bill would, in my opinion, prove injurious to the public because great confusion between a public accountant and a certified public accountant would result. The board of regents has communicated to me its formal disapproval.

"The bill is not approved."

Confusion Lurks in Duplication

This veto message of the governor describes in a few words the great and insuperable objection to two-class legislation. There can be no doubt whatever that the multiplication of laws involving regulation of any profession is undesirable. The public can not be expected to pursue an investigation of the exact significance of a variety of titles. The ordinary man of business has learned to know the designation "certified public accountant," and he regards it as the official indication that the authorities appointed by the state to regulate the practice of accountancy have granted their formal approval to the holder of the C. P. A. certificate. It indicates to the business man that the certified public accountant has a certain amount of education, that he has passed examinations of high standard and that he has been authorized to offer his services in a professional capacity to the people of the state. By adding another title of the same general character the public would be confused, and it seems probable that the present general understanding of the meaning of C. P. A. would be jeopardized by the creation of a parallel title. There are, of course, many arguments adduced on both sides of this question, but it is eloquent that the New York state society, a large and powerful organization, has consistently opposed the enactment of the two-class law. The board of regents, which is the ultimate authority in questions of professional practice in the state of New York, has expressed similar dissent. We wish to congratulate Governor Lehman upon his clear perception of the fundamental problem involved and upon the termination of another attempt to create a class of legislation which would be confusing.

Fifty Years of Great Accomplishment

The Society of Incorporated Accountants and Auditors celebrated the fiftieth anniversary of its founding in London, April 3rd, 4th and 5th. Representatives of the society from all parts of the world attended and there were delegations from the other principal organizations of accountants in Great Britain and abroad. The American Institute of Accountants was represented by I. Graham Pattinson, who offered the congratulations of the Institute at the meeting held in Incorporated Accountants' hall on April 4th. The record of the society's growth is impressive. In 1885 the society was incorporated with approximately 300 members. At the end of subsequent decades the membership was as follows:

1895.............	969	members
1905.............	2,111	"
1915.............	2,772	"
1925.............	4,435	"
1935.............	6,400	"

During its fifty years of active and progressive development, the society has become one of the leading organizations of accountants in the British dominions. It carries on its work throughout the world in complete harmony with the slightly older Institute of Chartered Accountants of England and Wales and with the Scottish societies. In the early days there may have been differences of opinion between the organizations, but that is all in the past and today there is cordial coöperation between the two. The society has maintained high standards for admission and has made for itself an important place in the body politic of Great Britain. To no small extent the credit for this splendid record is due to the first secretary, who is now the president, Sir James Martin, a man well known to American accountants who recall with pleasure his visits to this country. There have been many other able and earnest men who have participated in the growth of the organization and all of them deserve the highest commendation. The American Institute of Accountants in its original form was founded in 1887. It is, therefore, two years junior to the society of Great Britain and seven years junior to the institute in England. It is one of the satisfactory conditions of international accountancy that the two largest British societies as well as some of the smaller ones work closely with the American Institute in the development of a great profession. We are sure that we may speak for the entire membership of the Institute in extending cordial congratulations to the Society of Incorporated Accountants and Auditors.

The Annual Adventure

As this issue of THE JOURNAL OF ACCOUNTANCY goes to press the universities, colleges and schools are beginning to open their doors and to send out, into a somewhat indifferent world, thousands of young men and women filled with faith and enthusiasm and a little knowledge of the theoretical sort. It is impossible not to be impressed by the fervor and the confidence of these newcomers in the world of affairs. From their ranks will almost certainly arise the leaders of the next generation; but most of them, it must be admitted, will have heavy going and many heartaches and much despair when they find that this hard, matter-of-fact old earth pays little attention to them. At this time of the year the great question before anxious parents and enthusiastic graduates is: "What shall we do with this great accession to the wisdom of the world?" It must be confessed that in too many cases there is no thought for the future until the diploma is in hand. Too many men and women come out of college with only the vaguest notion of the use to which they will put their energies and such erudition as they may have acquired. Too often there seems to be a feeling that a certificate of graduation is of such transcendent significance that its possessor has merely to select the calling and his welcome will be instant and assured. At such a time the editorial offices of all technical magazines such as THE JOURNAL OF ACCOUNTANCY receive many letters of inquiry—some of them quite entertainingly condescending—asking what accountancy or engineering or one of the other vocations has to offer which will be sufficiently alluring to deserve acceptance by the graduate. The answer has been given a hundred times, but it seems to be necessary to return to the subject occasionally and to reiterate.

What Have We to Offer? "What has this accountancy of yours to offer?" "What is this accountancy, any way?" These are the questions which prevail in this spacious month of June. Sometimes follows another question: "Does it entail hard work?" When that last question is asked it is usually unnecessary to take the trouble to respond at all, for the young man going out into life who stops so early to think about the difficulty of the task will never accomplish anything. To the first question—What has this accountancy of yours to offer?—the reply may be something like this: Accountancy has to offer you pretty much what you will permit it to offer. If you have a firm belief that you have an analytical mind; if you are sure that you have a flair for mathematics, psychology, economics and finance, you will probably enjoy your work when you have found an opening in accountancy. And, of course, as every one knows, the work which one enjoys is the work which one can do best. Assuming, then, that you are naturally endowed with a taste for the problems and the substance of accountancy, this profession has to offer you a little difficulty in finding a door through which to enter and then, perhaps, three years as an assistant with some experienced man, when you will be required to do a great amount of uninteresting detail and you will not have much opportunity to demonstrate the magnificence of your mental powers. You will find that the work is uneven. During some of the months you will be on duty for long and trying hours and during part of the time there will be much less pressure and you can relax; but in most offices you will be expected to devote any unemployed hours to study and unremitting attempt to make yourself more valuable to your employers. At the end of three years or perhaps five years, depending upon your quickness of perception and your perseverance, you will be advanced, if you are still employed, to a position which pays a little more and gives you additional responsibilities. You will become what is generally called a semi-senior. In this chrysalis stage you will continue perhaps for two years, and then one day a partner or a manager will call you into his office and will tell you that you have done satisfactory work and that you are to be made a senior with the emoluments and the burdens which fall upon one who is considered competent to take charge of an engagement. From that point onward your future will be entirely your own. Your years of college training and your greater number of years of professional work will have begotten in you an ability to assume direction and a confidence quite different from that immature assurance which conceals itself in the rolled parchment of a diploma. Of course, you will understand that at any point in your progress in an accountant's office your career may suddenly terminate if you do not display the proper amount of application and ability. After you have become a senior, your rate of progression will depend largely upon the nature of the firm with which you are associated. Partnerships are not as a rule rapidly acquired—and, naturally, every staff accountant has a dream of partnership ever before him. It may be slightly reassuring to say that in most firms the senior partners are always on the alert to detect evidence of partnership ability and the man who has the real stuff in him will reach his partnership almost certainly.

What the Accountant Must Be

It is undoubtedly true that the trend in all the professions is toward an insistence upon a college education as a preliminary to entrance into professional work. The theory which underlies this trend is that the four years of college life should develop a power of reasoning and should at least assist in the building up of character. In accountancy the need for complete integrity is probably more manifest than in some other professions. The man who enters accountancy without an absolute and unshakable determination to tell the truth, whatever the cost, will not bring any benefit to his profession and in the long run will not succeed. Unfortunately there has been a great deal of idle and foolish talk about the enormous profits to be derived from the practice of accountancy. A few unscrupulous institutions have advertised widely that accountancy is the gateway to opulence, and so there has been attracted a class of young men for whom accountancy can hold nothing worth while. Sometimes they find their way into accountants' offices and linger there a year or two and then go out into some other walk of life where their peculiar characteristics are more welcome. But the blessed fact is that, with rare exceptions, the men who do not belong in accountancy do not remain in it. It takes a good deal of courage and faith and persistence to work one's way through the first few years. The monetary compensation will not be great, although it will probably be sufficient, and there will be many a night when the junior or semi-senior will go to his room to spend hours of self-analysis, when he will wonder whether or not he will ever achieve success. There will be many disappointments and heart-breaking failures, as there must be in every profession or trade. Nothing ever runs smoothly all the way, but after the testing years are over and a man has won his place in the profession and has earned the respect of his associates and the confidence of clients, it will be very pleasant, and the trials and tribulations of the early years will be forgotten. There is no profession which offers greater satisfaction to the established practitioner than does accountancy.

A Developing Profession

That inevitably brings up the second question which was propounded by our typical graduate: What is this accountancy, any way? Here the answer changes year by year. In this year of grace, 1935, the answer must be so entirely different from what it would have been twenty-five or thirty years ago that the old fellows of those days, if they could come back and listen, would not believe their ears. The beginnings of accountancy in America are so comparatively recent that they can be recalled without much delving into forgotten history. At the turn of the century accountancy was recognized to some extent by a few business men, and the accountants of that time were expected to perform perfunctory audits and particularly to investigate defalcations, embezzlements and the like. They were regarded by people who knew anything at all about them as expert bookkeepers with a sharp eye for crookedness and an almost uncanny ability to detect hidden infamy. A good many people seemed to regard them purely as detectives, a calling eminently respectable but based upon the existence of something to detect. Fortunately for the profession there were many very noble and able men who saw in their work its true and ultimate significance and by their own stalwart efforts and splendid characteristics impressed upon the public slowly but surely a little knowledge of what accountancy really could be and would be. Little by little business men, bankers, lawyers—these last very reluctantly—were brought to a knowledge of the true accountancy, which is not detective but rather constructive. The importance of the profession in those crescent days led to the enactment of regulatory laws in all the states and territories of the United States. Then, a little later, courts, federal departments and other agencies of national scope began to esteem accountancy and to hold in respect its reputable practitioners. The great war with its concomitant taxing measures advanced accountancy more rapidly than before. Then came the last and, we hope, the greatest disaster to American business—the depression of 1929 and the years succeeding. Business was thrown out of joint, everything was topsy-turvy, political changes of the most radical nature ensued, and the one discernible benefit arising from all the turmoil is a greater demand for explicit statement of financial affairs. The need for reform in corporate affairs had been tremendously exaggerated; nevertheless, everything was not as it should be and the spirit of reformation had ample justification for its existence. People who had no knowledge whatever of accountants and accountancy suddenly found themselves compelled to seek advice and assistance. Indeed, it is probably safe to say that the prestige of accountancy has increased in the past five years more than it did in any other similar period, with the possible exception of the years of the great war. The accountant today is an indispensable part of all corporate activity. He is required to have a knowledge of many things which were not dreamed of by his predecessors of the nineteenth century. He occupies a firm position in the councils of business and finance. His work is intensely interesting and, better than all else, his opportunities to serve his fellow man are almost unlimited. We may say, then, that this accountancy is something of the highest professional standing, the utmost national importance and the most enthralling interest. But again we are brought face to face with the increasing importance of the excellence of accountancy's personnel. The man who goes into accountancy thinking only of the day and the dollar will do infinite harm. Every man must think somewhat of the dollar, but he who puts the dollar first and the profession last is an enemy and should never be tolerated in the ranks. To sum up these notes, so strongly baccalaureate in manner, we may say to the young graduate that accountancy will welcome you, if you are appropriately equipped mentally and morally, and that, when you have attained an assured place in the profession, you will find the work delightful and the emoluments—which are not all monetary—satisfying.

The Collegiate Requirement

Elsewhere in these notes we refer to the trend toward the requirement that a professional accountant must have had a collegiate education before entering the profession. There is no doubt that this trend exists and that generally speaking it is commendable. There is, however, another side of the question which deserves a little consideration. For example, we have before us a letter from a correspondent in the far west who says in part:

"In the January issue of the JOURNAL there was an article by Warren W. Nissley in which he stated that he was an advocate of requiring in the near future a college degree from applicants for the C. P. A. certificate. For reasons which will be made clear in this letter, I felt considerable indignation but, lacking the experience of more mature years, I resolved to hold my tongue about it. However, my indignation has grown rather than abated. As an individual my case is relatively unimportant. However, there is, I think, a large group of individuals whose situation parallels my own. In 1925 I was graduated from an excellent high school. Lacking funds for a college education I accompanied my family to the west and secured employment. Later I changed jobs and shortly thereafter I had displayed enough ability to cause two men higher in the organization to encourage me to undertake the study of accountancy. This I did and for several years following was a regular attendant of commercial schools in the evenings. In these classes I found many men seriously undertaking to round out their education in general and giving specific attention to accountancy. By 1932, I felt I had progressed far enough to sit for the C. P. A. examination. I did—and failed. After another year's study I received credits from the Institute in all subjects and from the state in the law and auditing sections of the examination. Another year's study produced another failure. In November, 1934, six months later, I again sat for the examination and this time secured the final credits from the state. In the meantime my work has not suffered, as I am now in a minor executive position of considerable responsibility and trust. Now at the age of 27, am I not a better prospect for the accounting profession than a college man whose only qualification may be the completion of four years' study?"

College Education Not Absolutely Essential

This letter is, as its writer says, typical. There are many men who have had similar experiences. Some of them would probably make better accountants than the average college graduate without any practical experience, but that does not seem to be the real question at issue. If our correspondent is now well adapted to enter professional accountancy—in which, by the way, he seems to have had no experience whatever—would he not have been even better qualified if he had been fortunate enough to have had a college education as well? Every one knows that some of the founders of modern accountancy and many of its present leaders did not enjoy the privilege of a college career, yet we doubt if any one of these men would not admit that he had always regretted the lack of four years of college life. Not every one can spare the time or the money involved in collegiate study, but that is not to say that the thing which can not be had is therefore undesirable or of small value. The trend toward requiring collegiate training will never go so far that the man of real ability and aptitude can not sooner or later find his place in the profession. It is more difficult to rise to a commission in the army from the ranks than through the portals of West Point, but it does happen, and some of the finest officers in the service have never had the collegiate experience. In a word, then, it seems that the college graduate has an advantage over his non-collegiate colleague, but in the long run innate ability will be the thing that will count.

American Institute of Accountants' Examinations

[Following is the text of the examinations in auditing, law and accounting presented by the board of examiners of the American Institute of Accountants, May 16 and 17, 1935.]

BOARD OF EXAMINERS

Examination in Auditing

May 16, 1935, 9 a.m. to 12:30 p.m.

The candidate must answer all the following questions:

No. 1 (5 points):

(a) What is meant by "fixed" and "variable" overhead costs in cost accounting for a manufacturer?

(b) Give examples of each.

(c) How will increases and decreases in production affect the variable and fixed overhead in the cost per unit?

(d) Illustrate by example your answer to (c).

(e) Why should any distinction between fixed and variable costs be recognized?

No. 2 (15 points):

A summarized balance-sheet, presented to you for examination, is stated in the following terms:

Balance-sheet as at December 31, 1933

Assets		*Liabilities*		
Current assets	$1,600,000	Current liabilities		$ 800,000
Prepaid expenses	50,000	Contingency reserve		100,000
Plant account less reserve for depreciation	2,050,000	Preferred stock 7% Cum.		700,000
		Common stock		1,500,000
		Earned surplus: balance at Dec. 31, 1932	$450,000	
		Net income 1933	150,000	600,000
	$3,700,000			$3,700,000

According to the terms of the preferred-stock issue a sum of $50,000 is set aside annually "out of surplus" for the retirement of preferred stock, the instalment for each year to be deposited on March 1st of the succeeding year. At December 31, 1933, preferred stock of a par value of $300,000 had been retired through the sinking fund by purchases at par during the six years in which the fund had been in operation.

The contingency reserve was charged during the year with certain exceptionally large credit losses amounting to $100,000. When the contingency reserve of $200,000 was created by the board of directors out of surplus in 1931, it was felt that certain customers were receiving unduly long terms of credit, but it was the belief that they would eventually pay their bills. By 1933 balances to the amount of $100,000 were found to be irrecoverable, and they were written off against the contingency reserve, as stated.

Assuming that the current assets, the liabilities and the plant account have been satisfactorily verified, and that you have reviewed the operations of the company for 1933

(a) Submit your criticisms of the balance-sheet and discuss any points on which you may desire to take issue; and

(b) If you consider changes necessary, redraft the balance-sheet and present a summary of the surplus account, showing the sources of increase in 1933 and the proper distribution of the balance at December 31, 1933.

No. 3 (10 points):

While auditing an investment bank you learn that the president and treasurer hold similar positions in a savings bank in the same city and have unrestricted access to the securities of both banks.

(a) What would this situation suggest to you?

(b) How would you deal with it?

No. 4 (6 points):

You are making a balance-sheet audit of a concern whose business is importing and exporting. You find it has been the custom to charge to an account entitled "Freight and charges prepaid" all expenditures of that class on both incoming and outgoing shipments. At the close of each fiscal period the balance remaining in this account is written off as an operating expense.

A survey of the account for the past five years reveals the following facts:

Year	*Debits*	*Credits*	*Write-offs*
1930	$345,750	$342,000	$ 3,750
1931	298,500	294,700	3,800
1932	253,000	245,500	7,500
1933	258,750	242,000	16,750
1934	268,500	242,500	26,000

All charges are audited and approved by an "auditor," a clerk with a long record of trustworthy service, who neither handles cash nor draws cheques nor signs them.

(a) Discuss this procedure as it relates to the balance-sheet and earnings statement of the periods.

(b) In the circumstances would you consider it necessary or not to bring the matter to the attention of your client? Give your reasons.

No. 5 (15 points):

You are to certify the balance-sheet and income statement of the X Holding Company on a non-consolidated basis. In the course of the audit you find that its income account includes dividends from two wholly owned subsidiary companies which you do not audit. Concerning the latter you learn the following facts:

That subsidiary A had a net loss for the year but has had sufficient earned surplus since date of acquisition to cover the loss and the dividend paid; and

That subsidiary B had sufficient earned surplus at the date of acquisition to cover the dividend paid, but has suffered an earned-surplus deficit since, as well as a net loss for the year.

State in what manner, if at all, you will adjust the X Holding Company's balance-sheet or income statement, or how you will disclose the information you have obtained. Give your reasons in full.

No. 6 (9 points):

Auditing the books of the A Corporation in behalf of the X National Bank for credit purposes you find a substantial debit balance in an account entitled "Cash-surrender values." You learn that it appertains to policies in favor of the A Corporation on the lives of the principal officers.

(a) What steps will you take to verify this account?

(b) What information on this point will you give to the bank in your report?

(c) What, in particular, is it important for the bank to know? Why is it important?

No. 7 (5 points):

You have audited the accounts and certified the balance-sheet and earnings statement of the X Corporation for the year 1933. In 1934 the president of the corporation, knowing that you are suffering from lack of employment, offers you the privilege of selling a block of its stock on a commission basis. As a professional accountant will you accept the offer? Give your reasons.

No. 8 (10 points):

Corporation A, a trading company, owns all the stock of Corporation B, a real-estate holding company. Corporation B owns the real estate occupied by Corporation A for business purposes, subject to a mortgage which is owned by Corporation A. For the year ended Dec. 31, 1934, Corporation A pays rent of $4,000 to Corporation B, and receives from it interest of $6,000 on the mortgage and a dividend of $2,000 (from prior earned surplus) on the stock owned. Corporation B has a current net loss for the year of $4,000.

(a) State how you will report these facts for the income taxes of both corporations, and what the tax liability will be.

(b) If the same conditions had existed in 1933, what would the tax liability have been for that year?

No. 9 (15 points):

(1) What is "accounting control" as distinct from mere "ledger control"?

(2) State briefly how it may be applied in relation to:

(a) Plant and equipment
(b) Inventory
(c) Liabilities
(d) Income and expenses

(3) Is it always desirable? What could take its place in a control of a varied stock of supplies or retail merchandise?

No. 10 (10 points):

The A Corporation issued a million dollars face value of its own bonds at par in 1928. The terms of the bonds require the purchase of not less than 10% per annum of these bonds, which are to be deposited with a trustee and stamped "Held for sinking fund and not transferable." During 1934 the corporation purchased in the open market $100,000 par value of the bonds as follows:

$40,000 @ 98	$20,000 @ 120
30,000 @ 100	10,000 @ 130

and deposited them with the trustee.

State whether or not and to what extent, if at all, the difference between the issuing price and the purchase prices of the aggregate transactions should be reported in the corporation's federal income-tax return for 1934.

Examination in Accounting Theory and Practice

PART I

MAY 16, 1935, 1:30 P.M. TO 6:30 P.M.

Solve problem 1 or 2 and all other problems.

No. 1 (30 points):

The U. S. A. Company, a domestic corporation, purchased on January 1, 1931, a 90% interest in the capital stock of X Company, Limited, an English corporation, for the sum of $550,000. The U. S. A. Company acquired a further 5% interest in X Company, Limited, on June 30, 1932, for $25,000.

The following is a summary of the position of X Company, Limited, as shown by the reports of the local auditors:

	1931 January 1	1931 December 31	1932 December 31	1933 December 31
Current assets	£100,000	£110,000	£115,000	£125,000
Current liabilities:				
To U. S. A. Company (due in dollars)	4,000 ($20,000)	6,250 ($25,000)	6,000 ($21,000)	4,000 ($20,000)
To others (due in sterling)	£ 36,000	£ 58,750	£ 69,000	£ 61,000
	£ 40,000	£ 65,000	£ 75,000	£ 65,000
Net current position	£ 60,000	£ 45,000	£ 40,000	£ 60,000
Fixed assets—less reserves	£ 75,000	£ 70,000	£ 65,000	£ 65,000
Funded debt	20,000	20,000	20,000	20,000
Net fixed position	£ 55,000	£ 50,000	£ 45,000	£ 45,000
Total equity	£115,000	£ 95,000	£ 85,000	£105,000
Capital stock	£100,000	£100,000	£100,000	£100,000
Earned surplus*:				
Balance, January 1st	£ 15,000	£ 15,000	£ *5,000*	£ *15,000*
Profit or *loss* for year		*15,000*	*10,000*	20,000
Dividend paid June 30th		*5,000*		
	£ 15,000	£ *5,000*	£ *15,000*	£ 5,000
Total capital and surplus	£115,000	£ 95,000	£ 85,000	£105,000

* Italics indicate red figures.

Note:				
Earned surplus, June 30, 1932.........			*£ 10,000*	
Exchange rates on balance-sheet dates	5	4	3.50	5
Do. on June 30th		5	4	

Prepare:

1. A columnar statement whereon the U. S. A. Company's entries to its investment and surplus accounts are shown. Give full explanations on the statement.
2. A statement of revenue surplus showing the ultimate profit or loss on exchange with proper explanation of how it came about.
3. State briefly in what manner the exchange risks could have been averted.

No. 2 (30 points):

From the following municipal trial balance at the close of a fiscal year but before closing the books, prepare a balance-sheet, properly subdivided into funds, after giving effect to necessary entries of the general fund and the sinking fund as of the close of the year and to settlements of all inter-fund balances other than permanent advances:

	Dr.	Cr.
Accounts receivable general fund...........	$ 3,321.74	
Appropriation balances (unencumbered), general fund............................		$ 1,117.09
Assessments receivable....................	72,621.70	
Bond fund cash..........................	2,005.60	
Bond fund balance (unencumbered)........		678.00
Bonds payable, general capital account......		250,000.00
Bonds authorized and unissued............	8,000.00	
Contracts payable, bond fund..............		4,700.00
Due stores fund from bond fund...........		1,227.60
Due stores fund from general fund.........		1,593.96
Due stores fund from other funds..........	2,821.56	
Estimated revenues......................	1,500.00	
Fixed property..........................	897,640.00	
Fixed property (income-producing, trust fund)	62,000.00	
General fund cash.......................	1,842.10	
Income account, sinking fund.............		1,960.00
Interest account, special assessments........	620.00	
Loan from general to stores and service fund.	25,000.00	
Public benefit receivable (assessment fund) ..	6,400.00	

	Dr.	Cr.
Reserve for encumbrances, general fund		$ 2,827.10
Reserve for working capital		25,000.00
Reserve for retirement of bonds		160,000.00
Reserve for uncollectible taxes		2,875.00
Sinking fund cash	$ 1,450.00	
Sinking fund investments	160,000.00	
Sinking fund requirements	1,000.00	
Sinking fund surplus		490.00
Special assessment bonds		80,000.00
Special assessment fund cash	1,872.65	
Stores and service fund working capital (loan from general fund)		25,000.00
Stores and service fund cash	1,408.22	
Stores inventory	15,942.80	
Surplus receipts, general fund		896.00
Surplus, special assessment fund		1,514.35
Surplus invested in fixed assets		647,640.00
Taxes receivable, general fund	6,972.61	
Temporary loans, general fund		3,000.00
Trust funds balance		96,320.00
Trust fund cash	6,820.00	
Trust fund investments	27,500.00	
Vouchers payable, bond fund		3,400.00
Vouchers payable, general fund		1,327.30
Work in process, stores and service fund	4,827.42	
	$1,311,566.40	$1,311,566.40

No. 3 (20 points):

The December 31, 1934, trial balance of the Longwear Shoe Company before closing is as follows:

	Dr.	Cr.
Petty cash	$ 500	
The First National Bank	56,400	
Chicago store cash	775	
Accounts receivable	113,408	$ 1,260
Reserve for sales discount		4,800
Reserve for bad debts		15,000
Finished goods inventory	145,250	
Materials and supplies	271,800	
Office supplies inventory	1,600	
Chicago store inventory	11,700	
Prepaid insurance	2,800	
Land	5,000	
Buildings	156,000	
Reserve for depreciation—buildings		92,000
Machinery	34,500	

	Dr.	Cr.
Reserve for depreciation—machinery		$ 26,000
Chicago store fixtures	$ 4,400	
Reserve for dep'n.—Chicago store fixtures		3,700
Goodwill	100,000	
Accounts payable	355	37,500
Reserve for discount on inventory		4,050
Reserve for discount on accounts payable	1,750	
Accrued payroll		4,000
Reserve for taxes		5,600
Capital stock		200,000
Surplus		45,398
Sales		877,600
Purchase discount		13,000
Interest received		500
Sales discount	24,800	
Officers' salaries	20,000	
Office salaries	20,500	
Reserve for bad debts	7,700	
Office expenses	8,500	
Taxes	10,000	
Advertising	17,500	
Salesmen's salaries	13,400	
Salesmen's expenses	27,200	
Depreciation	6,570	
Taxes on building and machinery	4,000	
Heat, light and power	4,200	
Labor—foremen	17,500	
Labor—factory	212,700	
Lasts, dies and patterns	8,200	
Machinery rentals and royalty	16,000	
Repairs—factory	4,500	
Freight and cartage	1,200	
Sales—Chicago store		16,080
Cost of sales—Chicago store	9,040	
Depreciation of fixtures—Chicago	440	
Salaries—Chicago	2,400	
Miscellaneous expenses—Chicago	300	
Rent—Chicago	3,600	
	$1,346,488	$1,346,488

The average discount allowed on sales is 2%.
The average discount on purchases is 1%.
The actual inventories are as follows:

	Dec. 31, '33	Dec. 31, '34
Materials and supplies	$ 99,000	$102,500
Finished goods	151,000	146,300

	Dec. 31, '33	Dec. 31, '34
Office supplies	$ 1,600	$ 1,780
Chicago store	12,200	12,618

The discount taken in January on December 31, 1934, balances of accounts payable was $750.

Depreciation has been adjusted monthly on the company's books and is correctly stated.

Prepare balance-sheet and profit-and-loss account for the year —the latter to show loss or gain from operations of the store separately. Do not adjust taxes or surplus and disregard cents.

No. 4 (15 points):

You are engaged to audit the books and accounts of a beet-sugar refining company for the fiscal year ended March 31, 1934.

All the sugar refined during the year ended on that date was manufactured from beets purchased from growers under participating contracts whereby the growers receive 50 per cent. of the average net proceeds from the sale of all the sugar. The contracts run from October 1, 1933, to September 30, 1934, and provide for final settlement with growers at the latter date. They specify that, if all the sugar manufactured from beets furnished under the contract is not sold prior to September 30, 1934, the settlement for the unsold portion shall be made on the basis of the prevailing market price on that date less estimated cost of selling.

The company purchased 750,000 tons of beets under contracts with growers during the fiscal year under audit and the average sugar content of the beets was 18 per cent. with a per cent. extraction of 81.5. At the close of the fiscal year you find the company has sold 1,500,000 hundred-pound bags of sugar manufactured from the beets purchased during the fiscal year and that the average net return per bag for the sugar sold was $3.75.

On March 31, 1934, the company has paid the growers a total of $5.00 a ton for all the beets purchased. This was considered a minimum base price which would not be reduced, regardless of the amount of net returns. Only the actual payments to growers have been included in the computation of manufacturing costs and no liability to growers appears on the books.

At the time of your audit, which takes place five months after the close of the fiscal year, the market price of sugar has risen and a substantial portion of the sugar remaining on hand at the close of the fiscal year has been sold. Based on the result of these sales and the condition of the market the company officers estimate that the sugar on hand at March 31, 1934, will yield an average net return of $3.90 per bag.

1. Determine the liability to growers, if any, as it will appear on the audited balance-sheet of the company as at March 31, 1934, and show your method of computation.
2. What note would you attach to the balance-sheet explaining the liability?
3. What change would you recommend to overcome the uncertainty involved in estimating the liability at the close of the fiscal year?

No. 5 (10 points):

On January 1, 1934, Corporation X had an authorized and issued capital stock of 100,000 shares without par value. Of the amount of $50 a share received from the sale of such stock the directors, under the provisions of the company's charter, had assigned $20 a share as the stated value and $30 a share as paid-in surplus. Under the laws of the state in which the company is incorporated the board of directors may apply part or all of the paid-in surplus to the reduction or extinction of any operating deficit or to the payment of dividends. On December 31, 1934, the company had an operating deficit of $2,000,000 and had in its treasury 40,000 shares of its capital stock which it had acquired by the payment of $24 a share in cash.

Disregarding any question as to the legality of the transactions which have been described, prepare a statement of stockholders' equity at December 31, 1934,

(a) on the basis of the given data.
(b) assuming that the company had an earned surplus of $250,000 instead of an operating deficit of $2,000,000.

State briefly the reasons for the procedure you adopt.

No. 6 (10 points):

The following is a statement of the assets and liabilities of the co-partnership of Deed and Seal as at January 1, 1930:

Assets

Cash	$ 10,279.45
Investment in bonds	28,135.76
Accounts receivable	31,346.21
Inventory	44,281.95
Fixed assets (less depreciation, $2,973.06)	27,654.73
	$141,698.10

Liabilities

Accounts payable	$ 37,602.19
Capital:	
Deed	73,605.74
Seal	30,490.17
	$141,698.10

The partnership was dissolved on June 30, 1930. Seal then withdrew and was paid out of the partnership funds his capital, as shown in the statement at January 1, 1930, less withdrawals, together with $8,000 in lieu of his share of profits for the year up to that date. Deed continued the business but on July 1, 1930, was joined in co-partnership by Escrowe who purchased from Deed a one-quarter interest in the partnership for $25,000, the profits thereafter to be divided in the proportions of two thirds to Deed (his share in the former partnership) and one third to Escrowe. The books of the old firm, kept by single entry, were not closed when Seal withdrew but were continued by Deed and Escrowe and at December 31, 1930, the following statement was prepared:

Assets

Cash	$ 17,963.28
Investment in bonds	15,178.33
Accounts receivable	36,524.29
Inventory	57,183.46
Fixed assets (less depreciation, $4,753.69)	43,465.37
	$170,314.73

Liabilities

Accounts payable	$ 47,982.17
Capital	122,332.56
	$170,314.73

Deed withdrew $1,000 a month; Seal had drawn $500 a month, and Escrowe withdrew $500 a month. Particulars of the investment in bonds, as shown in the above statements, are as follows:

Cost of $25,000 6% bonds of OK and G Company, interest payable semi-annually, January 1st and July 1st	$28,135.76
Less:	
Proceeds of $12,500 bonds sold June 30, 1930	12,957.43
	$15,178.33

It has been agreed by the parties at interest that the income for the year 1930 is to be apportioned as follows: two fifths (2/5) for the half year to June 30th and three fifths (3/5) for the second half year, with the understanding that the loss from the sale of the bonds is a charge against the income of the first half of the year.

Prepare a statement of the three partners'-capital accounts and show how you determine the profits.

No. 7 (10 points):

The Dimenslot Company maintains a branch office in a distant city where the only financial transactions authorized are the collection and deposit in bank of receipts from automatic vending machines, the payment of branch payrolls and expenses and the remittance to the factory of funds in excess of branch requirements. Monthly reports of cash receipts and disbursements are sent to the factory.

In conducting an audit of the factory for a fiscal year ended June 30th, the auditor forwarded the twelve monthly cash reports to his representative in the city where the branch was located, with the request that they be compared with the records maintained at the branch and that such records be audited. In due course he received a report from his representative stating that the monthly reports were in agreement with the books and that the balance in bank at the end of the year had been verified directly with the depository. The representative also stated that the deposits as shown by the bank statements and the cheques issued by the branch exceeded, respectively, the receipts and disbursements shown by the books. Such excess, he stated, consisted of contra items, and he included, without further comment, the following summary of disbursements not appearing on the monthly reports and the branch books.

	(1) Bank loans, subsequently renewed	(2) Cheques returned, subsequently redeposited	(3) Cheques to employees	(4) Accommodation purchases
July	$ 4,600.00	$ 20.45	$ 58.24	$
August		200.00	400.00	271.80
September		15.00		707.84
October	4,600.00	37.25		750.00
November			5.00	

December..........	$ 3,000.00	$ 60.00	$ 223.40	$ 156.00
January............			300.00	
February...........			620.00	
March.............			200.00	
April..............				
May...............		23.50		
June...............			335.55	203.35
	$12,200.00	$356.20	$2,142.19	$2,088.99

What do you understand from each of the four numbered columns?

What would be the contra items for each of these classifications?

If you were the auditor, what objections would you have to the report made by the representative?

How would you dispose of this matter so far as your client is concerned?

No. 8 (5 points):

The City of Noware owns and operates the electric light plant serving the city. Bonds maturing in 20 years were issued to acquire the plant and, in terms of the issue, a sinking fund must be established by equal annual cash instalments to provide for the retirement of the bonds at maturity. Adequate depreciation is provided out of the revenue but it is alleged that, inasmuch as the taxes to be levied must include the annual sinking-fund payments, the amount thereof should be charged against the operations of the utility. If this is not done, it is argued, the earnings of the utility will be overstated by the amount of the sinking-fund contributions.

1. What is your opinion? Give reasons.
2. What should be done in case the trust deed under which the bonds were issued explicitly states that the sinking fund is to be charged against the operations of the utility?

Examination in Commercial Law

MAY 17, 1935, 9 A.M. to 12:30 P.M.

Reasons must be stated for each answer. Whenever practicable, give the answer first and then state reasons. Answers will be graded according to the applicant's evident knowledge of the legal principles involved in the question rather than on his conclusions.

GROUP I

Answer all questions in this group.

No. 1 (10 points):

Plaintiff made a written contract with defendant, a newspaper, whereby plaintiff agreed to become a passenger on an airship from a foreign country to the United States and during said passage to send radio messages to friends in reply to messages sent to plaintiff by said friends. Plaintiff's radio messages were to be reports of the flight which defendant was to publish and for which defendant agreed to pay plaintiff $5,000. Both plaintiff and defendant knew that plaintiff had agreed with the airship company as a condition of his being carried as a passenger that he would send no radio reports of the passage and both plaintiff and defendant knew that a third person had the exclusive news rights. Plaintiff fully performed his part of the contract. Can he compel defendant to pay him the $5,000?

No. 2 (10 points):

(a) In a transaction in which an owner of real property mortgages it upon obtaining a loan, describe all of the rights which the mortgagee acquires.

(b) What remedies does the mortgagee have for the enforcement of his rights?

(c) Define and explain equity of redemption.

No. 3 (10 points):

The maker of a valid promissory note legally procured defendant's endorsement prior to delivery of the note to the payee. Prior to maturity, the payee orally agreed with defendant and with the maker to release defendant as endorser and in consideration therefor defendant turned over certain valuable property to the payee. There was no written renunciation by the payee of his rights against defendant as endorser and the note was neither surrendered nor in any way marked or altered. Was defendant released as endorser so far as the payee is concerned?

No. 4 (10 points):

One joint adventurer began an action at law against his co-adventurer for money damages for alleged preventable losses sustained in the joint venture. Many items of debit and credit were in dispute between them. Was the action properly brought? If not, what remedy should the plaintiff have sought?

No. 5 (10 points):

Describe and explain the following terms so as to differentiate them:

(a) Agent.
(b) Servant.
(c) Employee.
(d) Independent contractor.
(e) Broker.

Group II

Answer any five questions in this group. No credit will be given for additional answers, and if more are submitted only the first five will be considered.

No. 6 (10 points):

Edward Engle and several other members of a club had endorsed a note made by the club. The club failed to pay the note and the payee procured from the president of the club a list of names and addresses of endorsers. This list was typewritten on club stationery which showed Engle's name as secretary and his address. The payee attempted to verify the addresses by examining the current telephone directory in which he found an Edward Engle at an address different from the one on the club stationery. Within the legally proper time the payee sent a notice in legally proper form to Edward Engle by registered mail at his address as stated on the club stationery. Two days later the post office returned this notice with a notation "Moved, left no address." Was the payee's notification of Engle sufficient to hold Engle as endorser?

No. 7 (10 points):

(a) Can a partnership be created in any way other than by express contract? If so, give an example.

(b) List (but do not discuss) the various causes for dissolution of a partnership otherwise than in accordance with provisions of the contract or articles of partnership.

No. 8 (10 points):

At a conference in the office of the Simpson Corporation, a duly authorized representative of the Tompkins Corporation arranged orally with a duly authorized representative of the Simpson Corporation for the Tompkins Corporation to sell to the Simpson Corporation merchandise of the value of $1,000. The representatives then prepared a memorandum of this sale on a Simpson form used by that corporation in selling merchandise to its customers, because the Tompkins representative had with him no order blanks of his own. At the top of the form the Simpson Corporation's name and address were printed. The name of the Tompkins Corporation was written on a blank line following the words "Sold to," and that corporation's address was written following the word "Address." These items and a description of the merchandise sold and the terms of the sale were written on the form by the Tompkins representative. Did the name of the Tompkins Corporation thus written constitute its signature under the statute of frauds?

No. 9 (10 points):

How can a director of a corporation protect himself from possible liability when a majority of the board adopts a resolution which he believes to be wrong (a) when he is present at the meeting, and (b) when he is absent from the meeting?

No. 10 (10 points):

What is cumulative voting? For what purpose is it employed? How does it accomplish its purpose?

No. 11 (10 points):

(a) Who may become a voluntary bankrupt?

(b) Who may be adjudged an involuntary bankrupt?

(c) Name at least four acts of bankruptcy.

No. 12 (10 points):

(a) In an ordinary bailment, what are the duties of a bailee for hire with respect to the custody and care of the bailor's property?

(b) Does a bank which holds corporate stocks pledged on a collateral loan have the same duties as a bailee for hire? If not, what are the differences?

(c) List the most important provisions of a bill of lading which is negotiable.

Examination in Accounting Theory and Practice

PART II

MAY 17, 1935, 1:30 P.M. TO 6:30 P.M.

Solve all problems.

No. 1 (25 points):

On December 31, 1933, a line of freighters—8 vessels of 6,000 tons, each costing $640,000 to build, or together $5,120,000, has outstanding $3,500,000 of capital stock, on which 11% was earned in 1933, after providing 5% for depreciation. It is assumed that thereafter each vessel will have the same gross earning capacity as in 1933, until it becomes obsolete after 20 years' regular operation. The vessels will not be replaced but will be sold at junk value at that time. No surplus or excess cash is allowed to accumulate, all funds in excess of requirements being distributed to the shareholders.

As the vessels grow older, the annual repair and maintenance costs increase as follows:

Up to	5	years old	1%	of original cost
" "	10	" "	2%	" " "
" "	15	" "	3%	" " "
" "	20	" "	4%	" " "

On December 31, 1933, the eight vessels owned are:

4– 3 years old
2–10 " "
2–12 " "

The line is offered on that date three similar vessels, respectively 8, 14 and 16 years old, for $880,000, payable in 6% bonds that fall due serially on December 31st of each succeeding year to the amount of the depreciation accrued in that year on the three vessels.

1. Prepare a statement showing the financial advantage or disadvantage of the purchase for each year in which any of the three vessels are operated.

2. What would be the advantage or disadvantage to the original shareholders (not to the company) in financing the purchase by the issue of common stock at par value?

No. 2 (20 points):

G and H are domestic companies whose audited balance-sheets of December 31, 1934, are as follows:

Assets	G	H
Cash	$ 15,000	$ 2,500
Accounts receivable—good and collectible	14,000	19,000
Marketable securities		
Owned by Company G (market value $10,000)	18,000	
Owned by Company H (market value $27,000)		27,000
Investment in Company K (wholly owned) represented by 5,000 shares—at cost (market value $1,000,000)	500,000	
Investment in H—book value (120 shares)	1,200	
Investment in G—book value (800 shares)		80,000
	$548,200	$128,500
Liabilities		
Accounts payable	$ 15,000	
Capital:		
6,000 shares, par value $100	600,000	
10,000 shares, par value $10		$100,000
Surplus		28,500
Deficit (italics indicate red figure)	*66,800*	
	$548,200	$128,500

Under a plan of reorganization the companies G and H are to be merged at December 31, 1934, to form a company J with an authorized capital of $2,000,000 representing 20,000 shares of $100 each. All shareholders agree to the merger except X who owns 100 shares of G and 2,000 shares of H. However, X will accept for his interest in the two companies an equivalent amount of company K shares at their market value. He will receive cash for any fractional part of a company K share.

The other shareholders will receive company J shares at their par of $100 each. They will pay or receive cash in lieu of fractional J shares and it is intended to pay out the smallest amount of cash to each of the two groups of company G and H shareholders.

1. How many shares of company K and how much cash are distributable to X?
2. How many shares of company J and how much cash are distributable to each of the two groups of shareholders G and H?
3. Prepare the opening balance-sheet of company J.

No. 3 (15 points):

State whether you agree with the following propositions and give the reasons for your opinion:

1. The accountant is and should be responsible for a correct valuation of inventories of materials, merchandise and supplies.
2. The accounts of all companies in which more than 51% of the voting stock is owned or controlled by the parent company should be included in a consolidation.
3. Any accounting principles which are prescribed by the United States Bureau of Internal Revenue for the preparation of income-tax returns should be followed in the books of the company and in any statements prepared therefrom.

No. 4 (15 points):

The Eastern Company, the Southern Company, and the Western Company are consolidated by the following method:

1. A new corporation, the Northern Company, is formed.
2. The Northern Company takes over all the assets and assumes all the liabilities of the three consolidating companies, paying for them as follows:

   To the preferred stockholders of the old companies, first-mortgage bonds of the new company at par. The total authorized bond issue is $400,000.

   To the holders of common stock:

   In the Eastern Company—30 shares of new stock for each share of old stock.

   In the Southern Company—10 shares of new stock for each share of old stock.

   In the Western Company—20 shares of new stock for each share of old stock.
3. The new company (the Northern Company) is capitalized at $1,000,000. (100,000 shares of a par value of $10 each.)

4. All properties are to be taken over at their book values.
5. The old companies are to be dissolved.

On the date of consolidation the balance-sheets of the three combining companies were as follows:

Assets	Eastern Company	Southern Company	Western Company
Land	$ 600,000	$ 30,000	$ 20,000
Buildings	20,000	100,000	25,000
Machinery and equipment	250,000	125,000	10,000
Inventories	75,000	100,000	20,000
Notes receivable	10,000		
Accounts receivable	165,000	325,000	160,000
Cash	30,500	35,000	15,000
Prepaid insurance, etc.	2,500	1,500	500
	$1,153,000	$716,500	$250,500
Liabilities and Net Worth			
Preferred stock—par $100	$ 300,000	$ 50,000	$ 50,000
Common stock—par $100	200,000	300,000	50,000
Notes payable	50,000	50,000	
Accounts payable	69,000	158,500	70,500
Accrued taxes	5,000	3,000	1,000
Unpaid wages	20,000	10,000	2,000
Reserve for depreciation:			
Building	4,000	20,000	5,000
Machinery and equipment	30,000	45,000	2,000
Surplus	475,000	80,000	70,000
	$1,153,000	$716,500	$250,500

The Western Company owed the Southern Company $24,000 on open account.

The $10,000 notes receivable of the Eastern Company represent notes of the Southern Company.

Prepare the balance-sheet of the Northern Company after the consolidation has been effected.

No. 5 (10 points):

You have been asked to make an examination of the accounts of a National Bank as at the close of its fiscal year and render a report to its board of directors.

A statement of the bank's earnings and expenses as published is as follows:

Earnings

Discount earned	$1,000,000
Interest on investments	1,750,000
Profit from sales of securities after considering a previous charge-off in the value of such securities to reserve for contingencies of $150,000	50,000
	$2,800,000

Expenses

Expenses	$1,200,000
Interest on time accounts	500,000
Taxes (federal and state)	250,000
Uncollectible loans	50,000
Reserve for contingencies	500,000
	$2,500,000
Net earnings	$ 300,000

In addition, you find that there has been (1) an appropriation or transfer of $2,000,000 from undivided profits to reserve for contingencies, (2) a write-down of $1,000,000 in the value of securities charged against that reserve and (3) a further charge of $1,000,000 against the reserve to cover actual loans considered worthless during the year.

In preparing your report what would you state to be the year's net earnings or loss which you would certify? Prepare a summary of the earnings statement.

No. 6 (10 points):

The Idaho Company has outstanding on January 1, 1933, 1,500 shares of common stock, par value $100, owned as follows:

James Owen	600 shares
Arthur Black	200 "
Fred Jensen	300 "
Thomas Carlyle	400 "

The surplus and reserves on the above date were: Surplus, $50,000 and reserve for bond sinking fund, $25,000.

During the year the company declared and paid a 4% dividend in June and declared a 4% dividend on December 20, 1933, payable January 10, 1934. The profits were $20,000, after depreciation, and $6,000 was charged to surplus as an addition to the sinking-fund reserve.

On January 1, 1934, the company purchased one half of Carlyle's stock at book value, and sold it on January 10th to Otto Seltzer for $190 a share.

During 1934 the company declared and paid a dividend of 9%. Its operating profits were $25,000 after depreciation. The accountant set up a reserve of $2,000 and the directors asked that the following amounts be added to the reserves: $4,000 for possible market declines in inventories, $10,000 for extension of plant and $3,000 for sinking fund.

1. Prepare journal entries for the purchase and sale of the stock in January, 1934.
2. Prepare a statement showing how the book values of the stock on December 31, 1933 and 1934 should be calculated.

No. 7 (5 points):

Following is a summary of the endowment funds of the State University:

Aggregate of the funds at July 1, 1933		$5,500,000
Increases: Sept. 1, 1933	$ 15,000	
Oct. 1, "	50,000	
Jan. 1, 1934	85,000	
Mar. 1, "	100,000	
May 1, "	25,000	
		275,000
Aggregate at June 30, 1934		$5,775,000

Included in the endowment funds is a fund for the Dowd Chair of Chemistry, viz.:

Balance of fund at July 1, 1933		$ 75,000
Increases: Oct. 1, 1933	$ 5,000	
Jan. 1, 1934	15,000	
May 1, 1934	10,000	
		30,000
Aggregate at June 30, 1934		$ 105,000

The total income for the year ended June 30, 1934, earned from the investment of all the funds, is $275,750.

Assuming that the securities in which the funds are invested are pooled:

1. What is the average rate of income earned during the year ended June 30, 1934?
2. What amount of the income must be applied toward the expenses of the Dowd Chair of Chemistry?

Practice Under the Securities Exchange Act *

By Albert J. Watson

Introduction

The federal securities act of 1933 deals with the issue of new securities to be sold in interstate commerce and stipulates the information to be furnished, so that the buying public may be fully aware of the essential elements necessary to exercise prudence in the purchase of such securities. The passage of that act gave added importance and recognition to the work of public accountants and was regarded as the most important legislation affecting the growth and practice of our profession in the United States since the passage of the state C. P. A. laws.

The security exchange act of 1934 deals with the regulation and control of the security exchanges as well as over-the-counter markets, the registration of securities, periodic reports from registrants and their officers and the control of margins and loans. Prior to the passage of this act the administration of the securities act was in the hands of the federal trade commission, but the securities exchange act created a new commission, known as the "securities and exchange commission," which is empowered to administer both the federal securities act of 1933 and the securities exchange act of 1934.

It will be recalled that the various investigations conducted by congress in 1932 emphasized the necessity of regulating the conduct of the stock exchanges and their members, as well as the need for greater publicity and information regarding the affairs of corporations whose securities are listed on such stock exchanges. Although the securities act of 1933, dealing with new issues, was the first passed by congress, the regulations promulgated under the securities exchange act had been under consideration at the same time. Most of the sections of the securities exchange act concern the buying and selling of securities and the registration and regulation of the security exchanges and their members. The act forbids the use of the mails in interstate commerce to any exchange which is not registered and, using this as a basis for the regulation of over-the-counter markets, empowers the commis-

* A paper presented before the San Francisco chapter of the California State Society of Certified Public Accountants, April 17, 1935.

sion to provide for registration of dealers in non-listed and over-the-counter securities. Members, brokers and dealers are prohibited from entering into any transactions on a security exchange unless the security is either exempted or registered under the act and it is principally in such registrations that the practice of public accounting is affected.

Act

The act itself justifies the necessity for such regulations by stating that "transactions in securities . . . upon exchanges and over-the-counter markets are affected with a national public interest," because these transactions are effected by means of the mails, they constitute an important part of interstate commerce, and they involve securities of those engaged in interstate commerce as well as the use of credit directly affecting the financing of trade and industry. The act points out that prices established or quoted constitute a basis for determining the purchase and sale price of securities, the amount of taxes payable to the United States and several states by owners, buyers and sellers, as well as the value of collateral for bank loans. It is recognized that frequently such prices are susceptible to manipulation and give rise to excessive speculation, unreasonable expansion and contraction of credit and that national emergencies, which produce widespread unemployment and dislocation of trade and adversely affect the general welfare, are precipitated, intensified and prolonged by manipulations and fluctuations of security prices. To meet such emergencies the federal government is put to such great expense as to burden the national credit.

Section 4 of the act establishes a security and exchange commission of five commissioners, appointed by the president with advice and consent of the senate and to hold office for a term of five years. Section 5 makes it unlawful for any broker, dealer or exchange to make use of the mails or any means or instrumentality of interstate commerce for the purpose of using any facility of an exchange to effect any transaction in a security or to report any transaction, unless the exchange is registered. Section 6 provides in detail for such registration. Most of the important security exchanges have already registered, although there are still a few in the smaller cities that have been allowed exemption up to this time.

I shall not discuss in detail section 7, which deals with margin requirements for the purpose of preventing excess use of credit in purchasing and carrying securities, nor section 8 which restricts borrowing by members of the securities exchanges. I would, however, point out that sections 9 and 10 prohibit many of the methods and devices heretofore in use in the manipulation of security prices. Joseph P. Kennedy, chairman of the securities and exchange commission, on April 16th asked the exchanges to enforce the rules devised by the commission to put a check upon manipulative practices. These rules are generally designed to prevent exchange members from profiting at the expense of their customers, to prevent excess trading and to restrict the personal-account operations of specialists to the needs of orderly markets. The commission has requested the exchanges to adopt these rules as their own, thus making the enforcement of the rules of the commission more flexible and in the manner of an experiment.

Section 16 requires the owner of more than ten percent of any class of an equity security registered on a national security exchange, as well as directors and officers, to file a statement of the amount of such securities owned, in addition to monthly reports if any changes have taken place in such ownership. The same section seeks to prevent unfair use of information by such owners, directors and officers to realize a profit on such securities, and it permits stockholders to bring suit to recover such profit.

Before I describe the section providing for registrations and reports, I should like to draw special attention to section 18, which deals with the liability for misleading statements. This section includes officers, directors and accountants and is as follows:

> "Any person who shall make or cause to be made any statement in any application, report or document filed pursuant to this title or any rule or regulation thereunder, which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading."

It will be observed that this section differs from section 11 of the federal securities act of 1933, which stated that an accountant may be sued by any person acquiring a security in case the statement or report prepared or certified by him contained an untrue statement of a material fact or omitted a material fact required to be stated therein or necessary to make the statements therein not misleading.

Although the technical language of the acts differs, the difference in degree of liability has been stated by Commissioner James M. Landis somewhat as follows: The accountant's liability under the exchange act places upon the accountant the necessity of establishing that he acted in good faith and had no knowledge that the statement was false or misleading in light of the circumstances in which it was made. The liability of the accountant under the securities act of 1933 is somewhat broader but, in substance, places upon him the necessity of establishing that he exercised due care as well as good faith and lack of knowledge of the false and misleading character of the statement. Another difference between these two liabilities is the lack of the reliance requirements in the securities act and the presence of the reliance requirements in the exchange act. Both liability sections, however, deal with material facts and the best definition of these words that I can find is: "A fact, the untrue statement or omission of which would be likely to affect the conduct of a reasonable man with reference to acquisition of holdings or disposals of the securities in question".

Both "material" and "fact" must be considered. What is material has naturally a relationship to something else as well as the circumstances. In stating facts the accountant must not confuse these with opinions nor must there be only representations of facts. I would recall that the amendments to the securities act redefined the standard of reasonableness as a defense by stating that the standard required is that "of a prudent man in the management of his own property." One can write his own definition of the average prudent man or prudent investor, who is the judge under the act as to liability. I question seriously if there be such a person or whether we could have any two courts agree on the specifications of such a person.

Section 13 empowers the commission to prescribe the rules for the filing of current information with the exchange and annual reports, certified if required by the commission and in such form or forms as the commission may demand. So far the regulations and forms dealing with periodical reports have not been published.

I come now to the section of the act—namely, section 12—which relates to registration requirements for securities and stipulates that it will be unlawful for any member, broker or dealer to deal in any securities on a national exchange, unless such securities are registered on such an exchange by the issuer by the filing of an application with the exchange and the commission. The section provides the details to be set forth in making such application. As most of these requirements in paragraphs "A" to "J" have been provided in form 10, I shall discuss them later. After registration the exchange authorities certify to the commission that the security has been approved by the exchange for listing and registration, and the registration then becomes effective within thirty days thereafter. I would point out that the commission itself does not consider the application or registration but merely provides rules and regulations and the avenue for publicity and the source of information for the security purchaser or holder.

Regulations and Forms

After the passage of the act, a committee of members of the national organizations of public accountants was formed to coöperate with the commission in devising forms and regulations for registration. A copy of the report of this committee was published in the *Bulletin* of the American Institute of Accountants on January 15th, and I would point out that of the seven recommendations made by the committee the first four were adopted and followed by the commission. This report advised that the financial information required should be limited to that which is of substantial value to investors and that, although uniformity of accounting principles is desirable as an ultimate objective, the registrant should only be required to indicate the principles which are followed. Throughout the forms and regulations resulting from the coöperation of the accountants and the commission there is evident a broad and sympathetic understanding of the problems of corporations which seek registration of securities and the limitations of presentation of facts in financial statements.

The form for application for registration pursuant to section 12, "b" and "c," of the securities exchange act of 1934 for corporations, known as form 10, emphasizes the fact that "the registrant may file statements and schedules in such form and order and using such generally used terminology as will best indicate their significance and character in the light of the instructions." This illustrates the spirit indicated throughout the instructions themselves. The regulations, of course, also provide means for the registration of securities issued and not yet listed and securities not yet issued. At the present time, we, as members of the profession, are particularly interested in the preparation of the financial data required under form 10 for the permanent registration of securities at present temporarily registered and listed on national security exchanges.

Form 10

For corporations temporarily registered and having a fiscal year ended December 31, 1934, the last date of filing financial statements in form 10 has been extended to June 30th, but as thirty days must elapse (after the commission receives certification that the security satisfies the listing requirements and has been approved for listing and that the exchange has received and approved form 10) before registration becomes effective and as such securities must be permanently listed not later than July 1, 1935, I doubt if any further extension can be granted. For corporations whose securities are at present listed temporarily, whose fiscal year closes after December 31, 1934, form 10 must be filed and agreement made to furnish financial and other data within ninety-three days after the closing of the fiscal year of the registrant.

As the first thirty-three requirements of form 10 deal with facts not intimately related to the financial statements I shall describe them only briefly. The first ten deal with the organization, No. 11 with the history and general character of the business and No. 12 with the location of its plants, etc. Nos. 13 to 16 provide for details of the funded debts of the registrant and its subsidiaries, its capital stock, securities, guarantees and warrants and rights. Nos. 18 to 22 call for details regarding funded debts and securities. Requirement 23 asks the registrant to furnish information regarding securities sold to any other than employees during the previous three years. Included under this requirement are the securities which the registrant itself has acquired and resold. Requirements 24 to 32 request certain information relative to names, addresses and salaries of directors and officers as well as remuneration paid to others in excess of $20,000; details of the securities of the registrant owned "of record" by anyone holding over 10 per cent. of any class of equity securities of registrant; and similar information for holdings (of record or beneficially) of directors, officers and others. Details are also requested of bonuses in excess of $30,000 and of management and other contracts. No. 33 requires all information regarding options to purchase securities from registrant.

No. 34 is of particular interest to accountants, not only because of the information requested, but also because the answers shall be separately certified by (a) the directors, (b) the chief accountant of the registrant or (c) independent public accountants or independent certified public accountants. Item "K" of section 12 of the act empowers the commission to request any further financial statements it may deem necessary for the protection of investors. Many changes have been made by corporations, both in their capital structure and valuations of assets during the past few years, and for that reason this detail, which is the only historical information called for in the form, has been requested. The commission requires, under No. 34, similar information from the parent company as well as the subsidiaries, consolidated and unconsolidated, as to the increases and decreases in investments in properties, plant and equipment or intangible assets resulting from substantially revaluing such assets. The dates of such revaluation, amounts of write-ups and write-downs and accounts affected, including contra entries and adjustments to related reserve accounts for the period from January 1, 1925, must be given with explanations. No. 34 also requires the registrant to furnish, for the same period, details of any restatement of the capital stock of the parent and subsidiaries—the amount and contra entries are to be given. If there has been an original issue of capital stock and particularly if any part of the proceeds were credited to surplus, these amounts must be stated. Having in mind the fact that published earnings of corporations have been affected by the writing off of bond discount and expense, information of any such amounts written off earlier than required since January 1, 1925, must be furnished and the accounts affected must be indicated. I understand that it was suggested that the scope of this requirement be extended to include the analysis of surplus for the ten-year period, but the accountants' committee pointed out that this would be undesirable and that the information otherwise required would probably account for all important matters affecting the surplus accounts.

Under rule UB-2, published by the commission, if any registrant filing an application, a report or document wishes to object to the disclosure of the information contained therein he may file that portion of such document containing such information separately and marked "confidential", with written objections as to why such disclosure is not in the public interest. Unless the commission determine that such information shall be disclosed, it shall be kept confidential.

The definitions set forth in instructions for form 10 are worthy of careful study by all accountants. The following items are of particular interest:

1. The term "*control*" (referring particularly to parent companies) means the possession directly or indirectly of the power to direct or cause the direction of the management and policies of a person whether through the ownership of voting securities by contract or otherwise.
2. The term "*affiliate*" refers to a person that directly or indirectly through one or more intermediaries controls or is controlled by or is under common control with the registrant.
3. The term "*parent*" refers to an affiliate controlling the registrant directly or indirectly through one or more intermediaries.
4. The term "*subsidiary*" refers to an affiliate controlled by the registrant directly or indirectly through one or more intermediaries.

Financial Statements

The financial statements required are:

1. Balance-sheet.
2. Profit-and-loss statement.
3. Consolidated balance-sheet and consolidated profit-and-loss statement prepared in accordance with rules of the commission regarding consolidation.
4. For subsidiaries not consolidated:
   (a) Separate consolidated or combined statements, or
   (b) Individual statements for each subsidiary.

An amendment provides that consolidated statements alone may be submitted where the registrant is primarily an operating company and the subsidiaries are in practical effect operating divisions of the registrant.

Throughout the instructions dealing with these statements and the schedules supporting them the commission has undertaken to announce a number of accounting principles and requirements for presentation. Particular stress has been laid on disclosure as to methods used, and in these respects I believe form 10 and other forms published by the commission have materially aided the accounting profession in establishing the practice and procedure which every accountant has desired to follow in the past but frequently has been unable to follow because of the opposition of clients. This, I believe, is a long step in the right direction and, I should like to review briefly these principles or methods or requirements of disclosure in the instructions relative to the preparation of the various statements and schedules:

Accounting principles: If any changes in accounting principles or practices have been made during the period covered by the profit-and-loss statements and such changes affect a proper comparison with statements for the preceding accounting period, the necessary explanations must be given by foot-note to the balance-sheet or profit-and-loss statement.

Foreign exchange: Basis for conversion of all items in foreign currency shall be stated and the amount and disposition of resulting unrealized profits or losses shown if significant. This requirement is necessary for both balance-sheet and income account.

Subsidiaries: (a) When the assets or revenues are significant, separate statements of subsidiaries not consolidated must be furnished where the registrant owns over 50 per cent. of the voting power.

(b) The registrant shall not consolidate companies in which it does not own, directly or indirectly, securities representing more than 50 per cent. of the voting power, subject to the provision that it shall follow the principle of inclusion or exclusion which in the opinion of its officers shall most clearly reveal the financial position of the registrant and its subsidiaries. The principle adopted shall be stated in a note to the consolidated statement.

(c) If the fiscal year of a subsidiary ends on a date different from that of the registrant, it may be consolidated if the difference is not more than 93 days, if the closing date is indicated, and if the necessity for use of a different date is explained and any changes in the respective fiscal periods of both the registrant and subsidiary made during the period of report are indicated.

Consolidated balance-sheet: (a) The consolidated balance-sheet must show separately the minority interest in capital and surplus of the subsidiaries consolidated.

(b) By foot-note or otherwise must be reflected the extent to which the equity of the registrant in its unconsolidated subsidiaries has been increased or diminished since the date of acquisition, as a result of profits, losses and distributions.

Consolidated profit-and-loss accounts: (a) The principle under which inter-company profits and inter-company sales are handled in the consolidated profit-and-loss account must be stated. In general these items shall be eliminated but where not eliminated the reasons should be stated.

(b) The registrant's proportion of the sum of or difference between current earnings or losses and the dividends declared or paid by unconsolidated subsidiaries shall be shown by footnote or otherwise.

(c) For subsidiaries consolidated the difference between the investment in such subsidiaries as shown by the books and the equity in the net assets in said subsidiaries as shown by the books of the latter must be stated, and the principle adopted must be indicated.

The specific requirements for balance-sheet, profit-and-loss statement schedules, etc., should of course receive the careful attention of accountants.

Examination by and Certificate of Public Accountants' Certificate

Form 10 provides that the financial statements submitted with the registration statement shall be accompanied by a certificate of independent public or independent certified public accountants. The regulations issued under the federal securities act of 1933 prescribed the concluding paragraph of the accountant's certificate to be attached to the balance-sheet and profit-and-loss accounts required in form "A-1". This, however, has been amended and the specifications outlined for accountants' certificates under both acts are now identical. The former requirement that a partner signing the partnership name should also sign his own name has been omitted. The principal specifications of the certificate as contained in the instructions in form 10 may be enumerated as follows: (1) It shall be dated; (2) It shall be reasonably comprehensive as to scope; (3) It shall state the opinion of the accountant in respect to the financial statements and the accounting principles and procedures followed by the registrant.

The American Institute of Accountants, through its special committees on coöperation with the security and exchange commission, has expressed the hope that the suggested form for accountants' reports agreed upon by the special committee of the Institute on coöperation with stock exchanges and the committee on stock list of the New York stock exchange can be used substantially as a basis for the accountants' certificate under the various regulations of the commission.

Scope of Examination

As a practical matter all accountants will wish to know how this new legislation has in any way extended or restricted the scope of their examination and the detailed work involved under the programs of examination and audit. In the instructions under form 10 the commission did a great favor to the profession by recognizing the restricted scope of periodical examination by stating that "accountants may give due weight to an internal system of audit regularly maintained by means of auditors employed on the registrant's own staff. In such case the accountants shall review the accounting procedures followed and by appropriate measures shall satisfy themselves that such accounting procedures are in fact being followed." It should be borne in mind that the examination of the accounts of a corporation for the purpose of preparing financial statements over a period of years, to be submitted to a prospective security buyer, differs somewhat in scope from the annual examination made by an accountant for his regular client. I can do no better than recommend as a basis for the program of the accountant in making an examination for form 10 the revised booklet published by the federal reserve board in 1929 known as *Verification of Financial Statements* which was the work of a special committee of the American Institute of Accountants. I believe you will find this furnishes a comprehensive program for such an examination and will develop the information necessary for the verification of the financial statements and preparation of schedules. As the instructions for form 10 indicate generally what is to be included under each item of assets and liabilities on the balance-sheet and also call for specific items of the profit-and-loss account and as the various notes furnished under the forms of the various schedules instruct the registrant in the preparation of these statements, it is unnecessary to review them in detail.

The instructions, I believe, are in accordance with the best in present practice and emphasis is given to up-to-date thought and opinion. The commission has stated that it consulted a large number of persons, not only accountants but also businessmen, bankers, brokers and professors. Recognition has been given to Professor Sanders' objection to the use of the word "value" on a balance-sheet and his recommendation that accountants should recognize the distinction between "amount" and "value." I believe accountants agree that cost of property rarely represents the present value, and market quotations of securities are not always realizable values.

CONCLUSION

The practice of accountancy under the requirements of the securities act and the securities exchange act has been beneficially affected not only by the recognition of the advantage to stockholders of requiring examinations by public accountants but also by the enunciation by a government agency of certain accounting principles without attempting uniformity. No longer must the public accountant single-handed strive against the prejudiced desire of the officers of clients for what he believes to be fair and correct presentation of facts in the financial statements. Whether the client be a registrant of securities on the exchanges or not the published rules of the commission based on these federal laws should prove an important ally for the practising accountant. Some members of the profession may object to principles and standards set by any government agency as being too restrictive for the proper practice of a profession in what is not an exact science, but we can not ignore the continued criticisms of investors, bankers and others regarding the statements published in stockholders' reports in past years and particularly the lack of adequate description of items and proper disclosures. The investor looks to the public accountant to help to educate the management of clients, and we must pledge our coöperation because only by so doing can we avoid the objectionable results which would come from the requirement of uniformity of accounts and statements by government agencies. By coöperation with the commission in the administration of these securities acts there is assurance for the profession's continued growth and responsibility. Surely we can accept the challenge of Commissioner Landis to do our part in bringing about "candor, honesty and integrity in corporate finance."

Income-tax Algebra

By Harry H. Wade

State income tax is a deduction on the federal return, and federal income tax is a deduction on the state return. As a result, income-tax algebra is necessary where a taxpayer is on the accrual basis. (It is interesting to note that taxpayers who report on the cash basis are not bothered by algebraic computations.) Consider the simplest of problems concerning corporation "A" for 1934.

Given:

	Per state law	Per federal law
Gross income	$250,000	$370,000
Allowable deduction except income tax accrued	50,000	70,000
Net income per state law before deducting federal income tax	$200,000	
Net income per federal law before deducting state income tax		$300,000
Rates	2%	13¾%

State income tax for 1934 is deductible from federal income before computing federal tax, and, simultaneously, federal income tax for 1934 is deductible from state income before computing state tax. Obviously one can not be determined before the other one is known.

Solution:

Let x = state tax

Then 13¾% of (\$300,000.00 − x) = federal tax

And 2% of [\$200,000.00 − 13¾% (\$300,000.00 − x)] = x

Solving for x:

$$.02\,[\$200{,}000.00-(\$41{,}250.00-.1375x)]=x$$

or

$$.02\,[\$200{,}000.00-\$41{,}250.00+.1375x]=x$$

or

$$\$4{,}000.00-\$825.00+.00275x=x$$

or

$$.99725x=\$3{,}175.00$$

and

$$x=\$3{,}183.75 \text{ (state tax)}$$

Federal tax = 13¾% (\$300,000.00 − \$3,183.75) = \$40,812.23

Proof:

$$2\% \ (\$200{,}000.00 - \$40{,}812.23) = \$3{,}183.75 \text{ (state tax)}$$
$$\$3{,}183.75 = \$3{,}183.75$$

Two Suggestions

1. Why not change the federal law to require deduction of state income tax in the year paid even where the taxpayer is on an accrual basis? This would eliminate algebraic computations beginning with the year in which this change would become effective. No change in state laws would be necessary.

2. If coöperation between state and federal governments could be secured, another method is possible. Change the laws to say: "State income tax is a tax credit on the federal return and federal income tax is a tax credit on the state return—" these credits to be computed after all other tax credits have been made. For example, consider the solution of corporation "A's" problem under this suggested ruling.

Solution:

	State	Federal
Gross income	$250,000	$370,000
Total allowable deductions	50,000	70,000
Net income subject to tax	$200,000	$300,000
Rate	2%	13¾%
Tax	$ 4,000	$ 41,250
Less tax credit:		
2% of $41,250	825	
13¾% of $4,000		550
Tax payable	$ 3,175	$ 40,700

Income-tax algebra is entirely eliminated. Comparison of tax payable under the present 1934 laws and the suggested rule favors the taxpayer slightly, but the advantage of improving the workability of the law and the reaction of the taxpayer far outweigh, in my opinion, the slight sacrifice in revenue. Even where there is a federal excess-profits tax to be paid, no algebra would be necessary. The state and federal returns could be prepared independently and tax credits taken as follows:

	State	Federal (assume adjusted) declared value—$1,000,000)
Gross income	$250,000	$370,000
Total allowable deductions	50,000	70,000
Net income	$200,000	$300,000
Rate	2%	13¾%
Tax	4,000	41,250
Excess-profits tax		8,750 (5% of $300,000 − $125,000)
Total tax	$ 4,000	$ 50,000
Tax credit	1,000 (2% of $50,000)	550 (13¾% of $4,000)
Tax payable	$ 3,000	$ 49,450

To the mathematician income-tax algebra is elementary, but to many taxpayers it is confounding. Many men, otherwise strong, tremble when they read, "Let x equal so and so." Perhaps neither of the suggested changes is acceptable, but something should be done to relieve the taxpayer of complicated computations.

Examples of Income-tax Algebra

The following examples are based on the Iowa 1934 law and the federal 1934 law. They are presented merely to illustrate the complexity of computations required.

Example I

To find accrued state and federal income tax where corporation has insufficient income to pay federal excess-profits tax.

Assume:

(1) State tax rate = 2%

(2) Federal tax rate = 13¾%

(3) Net income subject to state tax before deducting federal income tax = Sn

(4) Net income subject to federal tax before deducting state income tax = Fn

Let: x = State tax

Then: $13\frac{3}{4}\%\ (Fn - x)$ = federal tax

And: $2\%\ [Sn - 13\frac{3}{4}\%\ (Fn - x)]$ = state tax $= x$

Solve for x:

$2\% \, [Sn - .1375 \; Fn + .1375x] = x$

$.02 \; Sn - .00275 \; Fn + .00275x = x$

$.02 \; Sn - .00275 \; Fn = .99725x$

or

$$x = \frac{.02 \; Sn - .00275 \; Fn}{.99725}$$

(This formula is applicable only where state rate is 2% and federal rate is 13¾%. When rates vary a formula may be developed by substituting proper rates in the development of this formula.)

For example:

Let $Sn = \$200{,}000.00$
$Fn = \$300{,}000.00$

Then:

$$\text{State tax} = \frac{.02 \; (\$200{,}000.00) - .00275 \; (\$300{,}000.00)}{.99725}$$

$$= \frac{\$4{,}000.00 - \$825.00}{.99725}$$

$$= \$3{,}183.75 = \text{State tax}$$

And federal tax = 13¾%(\$300,000.00 − \$3.183.18) = \$40,812.23 = federal tax

Proof:

$2\% \; (\$200{,}000.00 - \$40{,}812.23) = \$3{,}183.75$

$2\% \; (\$159{,}187.77) = \$3{,}183.75$

$\$3{,}183.75 = \$3{,}183.75$

Example II

To find accrued state and federal income tax where corporation has contributions to charity which are deductible on state return, (as in Iowa), and where such contributions obviously exceed the 15% limitation.

(Where such contributions obviously do not exceed the 15% limitation, one should use the formula of example I, but let $Sn =$ net income before deducting federal tax but after deducting contributions. Where it is not obvious that contributions do or do not exceed the 15% limitation, then the problem must be worked as in example I and then as in example II. The correct solution will be apparent.)

Assume:

(1) State tax rate = 2%
(2) Federal tax rate = $13\frac{3}{4}$%
(3) Net income subject to state tax before deducting federal tax and before deducting contributions = Sn
(4) Net income subject to federal tax before deducting state income tax = Fn

Let: x = state tax
Then: $13\frac{3}{4}\%\ (Fn-x)$ = federal tax
And: $15\%\ [Sn-13\frac{3}{4}\%\ (Fn-x)]$ = limitation of contribution
Then: 2% of Sn, less the contributions and less the federal tax will equal the state tax, or

$$2\%\ (Sn-15\%\ [Sn-13\tfrac{3}{4}\%\ (Fn-x)]-13\tfrac{3}{4}\%\ [Fn-x]) = x$$

Solving for x:

$$2\%\ (Sn-15\%\ [Sn-.1375\ Fn+.1375x]-.1375\ Fn+.1375x)=x$$

or

$$2\%\ (Sn-.15\ Sn+.020625\ Fn-.020625x-.1375\ Fn+.1375x) = x$$

or

$$2\%\ (.85\ Sn-.116875\ Fn+.116875x)=x$$

or

$$.017\ Sn-.0023375\ Fn+.0023375x=x$$

or

$$.017\ Sn-.0023375\ Fn=.9976625x$$

or

$$x=\frac{.017\ Sn-.0023375\ Fn}{.9976625}$$

For example:

Let Sn = \$200,000.00 (contributions of \$40,000 not deducted from this.)
Fn = \$300,000.00

Then: $$x=\frac{.017\ (\$200{,}000.00)-.0023375\ (\$300{,}000)}{.9976625}$$

$$x=\frac{\$3{,}400.00-\$701.25}{.9976625}=\$2{,}705.07 \text{ (state tax)}$$

Then: $13\frac{3}{4}\%$ (\$300,000.00 − \$2,705.07) = federal tax
= \$40,878.05

And: Contribution deduction for state return equals: 15% (\$200,000.00 − \$40,878.05) = \$23.868.29

Proof:

2% (\$200,000.00 − \$23,868.29 − \$40,878.05) = \$2,705.07
2% (\$135,253.66) = \$2,705.07
\$2,705.07 = \$2,705.07

Example III

To find accrued state and federal income tax where corporation obviously has to pay the federal excess-profits tax. (Where payment of excess profits tax is doubtful, solutions must be made as in example I and example III. Correct solution will be distinguishable.)

Assume:

(1) State tax rate = 2%
(2) Federal tax rate = $13\frac{3}{4}\%$
(3) Net income subject to state tax before deducting federal income tax and federal excess-profits tax = Sn
(4) Net income subject to federal tax before deducting state income tax = Fn
(5) Adjusted declared value = D

Let: x = state tax

Then: $13\frac{3}{4}\%\ (Fn-x)$ = federal tax
$5\%\ [(Fn-x)-12\frac{1}{2}\%\ D]$ = excess-profits tax

Then: 2% of Sn, less the federal income tax and less the excess-profits tax = state tax or x

That is:

$$2\%\ (Sn-13\tfrac{3}{4}\%\ [Fn-x]-5\%\ [Fn-x)-12\tfrac{1}{2}\%\ D])=x$$

Solve for x:

$$2\%(Sn-.1375\ Fn+.1375x-.05\ Fn+.05x+.00625\ D)=x$$

or

$$2\%(Sn-.1875\ Fn+.1875x+.00625\ D)=x$$

or

$$.02\ Sn - .00375\ Fn + .00375x + .000125\ D = x$$

or

$$.02\ Sn - .00375\ Fn + .000125\ D = .99625x$$

or

$$x = \frac{.02\ Sn - .00375\ Fn + .000125\ D}{.99625}$$

For example:

$$Sn = \$200{,}000.00$$
$$Fn = \$300{,}000.00$$
$$D = \$1{,}000{,}000.00$$

$$x = \frac{\$4{,}000.00 - \$1{,}125.00 + \$125.00}{.99625} = \underline{\underline{\$3{,}011.29}} \text{ (state tax)}$$

Federal tax $= 13\frac{3}{4}\%$ (\$300,000.00 − \$3,011.29) = $\underline{\underline{\$40{,}835.95}}$

Excess-profits tax $= 5\%$ (\$300,000.00 − \$3,011.29) − $12\frac{1}{2}\%$ (\$1,000,000.00)
$= 5\%$(\$296,988.71 − \$125,000.00)
$= \underline{\underline{\$8{,}599.44}}$

Total federal tax $= \underline{\underline{\$49{,}435.39}}$

Proof:

2% (\$200,000.00 − \$40,835.95 − \$8,599.44) = \$3,011.29
2% (\$150,564.61) = \$3,011.29
$\underline{\underline{\$3{,}011.29}} = \underline{\underline{\$3{,}011.29}}$

Other examples of a more complex nature could be given. Conditions of examples II and III could be combined. If the reader has followed the computations thus far with understanding, he is capable of developing formulæ as needed; otherwise there is no point in adding further confusion.

"Auditor Independence"

By Bishop C. Hunt

As an economist who has pursued some interest in the development of English company organization and control, I venture to comment on several matters discussed in a recent article in The Journal of Accountancy by A. C. Littleton entitled "Auditor Independence." In the first place, I think his views of English practice are mistaken. Secondly, while I have no doubt that he has the best interests of the profession at heart, I am convinced that his proposals for the organization of audit practice and practitioners are unsound, not only from the point of view of the progressive development of accountancy in this country, but as well, from that of the security of shareholders for which we are all solicitous. If adopted, they would, in my judgment, bind accountancy in the fetters of an inevitably mediocre bureaucracy.

It will be worth while to take a brief glance at the evolution of the English law in the matter. "Periodical accounts," Gladstone declared in 1844, "if honestly made and fairly audited can not fail to excite attention to the real state of [a] concern." In accordance with this view, all joint-stock companies formed under the registration and regulation act of that year, were required, as a prerequisite of legal sanction to do business, to appoint auditors "to receive and examine the accounts." Directors were to cause "A full and fair balance-sheet to be made up" and to approve it before delivery to auditors. Similar provisions were included in the act of 1845 to govern companies established by special act of parliament. Auditors, it is interesting to note in passing, were empowered to employ the assistance of professional accountants. The compulsory requirement of audit was dropped in the effective general statutes for the incorporation of companies with limited liability, those of 1856 and 1862. However, the provision was retained in the model (and optional) constitution for such companies, set up in table A of the act of 1862 and probably adopted by a majority of concerns. Compulsory and independent audit for banks was legislated in 1879. Under the combined influence of a growing complexity of accounts and fear of penalties, practice gradually substituted the professional for the lay auditor so that by the act of 1900, under which the appointment of auditors became compulsory for all companies, the accounts of most of them were not only audited but were in fact audited by chartered accountants (cf. *The Accountant*, Vol. XXVI [1900], p. 475). Indeed, practice has generally outrun legal minima. The stiffening of requirements over the years has, in fact, merely translated into statute the best of the current professional practice.

Undoubtedly, the most important characteristic of English company law and practice today is the position of the auditor. With relation both to shareholders and to directors, he occupies an independent status. Appointed by the annual general meeting of shareholders, he may be neither an officer nor a director of the company nor an employee of any director or officer. He may not be indemnified by the articles of a company for negligence or breach of trust. He is liable to proceedings for misfeasance, in the same fashion as directors. He is entitled to attend and to address any general meeting of shareholders before which accounts are to be laid. It is also to be mentioned that the board of trade may appoint inspectors to investigate the affairs of any company upon the application of members holding 10 per cent. of the shares issued, if it is supported by evidence showing good reason and the absence of "malicious motives."

The lack of auditor independence in England which Mr. Littleton alleges, and in which he seems to find an important argument for the nationalization of the profession in our own country, will be found on adequate acquaintance with the facts of English business life to be insignificant. In the first place, an auditor is obliged by law to state in his certificate whether directors have satisfied his requirements as to information. If they had not, it is fair to say, I think, that in the great majority of cases he would refuse to certify. At least seven days in advance of the general meeting before which they are to be laid, a copy of the balance-sheet and auditors' report must be sent to all shareholders entitled to attend. To put it mildly, directors would be under some embarrassment if they had to confront such a meeting of English shareholders without their auditor's certificate, to say nothing of the effect upon the company's credit. As already pointed out, auditors may, as of right, attend and address the general meeting before which accounts are laid. In other words, they have a right to be heard before being dropped. Furthermore, in view of the exacting standards of professional ethics among members of the great societies of accountants, it would be difficult, to say the least, to fill the places of auditors who had retired on the score of pressure from directors to slight their duties, and such pressure would in the vast majority of cases lead to resignation. No firm of any reputation would consider appointment in the room of others without consultation first on the circumstances of withdrawal or dismissal with those who had retired. The existence of a high degree of professional comity in such matters is not to be overlooked. Moreover, it does not embroider the facts to say that the accounts of the great majority of the large public companies—those which appeal to the market for capital and whose incidents of ownership are widely diffused—are audited by accountants of high calibre. Despite the circumstance, then, that directors in office may in some cases dominate a meeting of shareholders and so nominate auditors indirectly, the general standards of the profession are a sufficient realistic safeguard of auditor independence.

While auditor independence is not, therefore, an issue in English company regulation, the requirements as to disclosure of accounting results are admittedly inadequate, and practice in this matter both as to form and content suffers by comparison with the best which prevails in the United States. Although the reforms of 1928 were a considerable advance, they left serious lacunæ. Much information, the publication of which the law might reasonably require, remains cloaked in "Victorian garments of secrecy." Published accounts are indeed often "a model of obscurity" (see my article in *Harvard Business Review*, January, 1930). Forward-looking accountants (and others) are convinced that the requirements as to publicity should be broadened, for unfortunately the irreducible minima prescribed by law become maxima in practice. However, as far as the prerogatives of the auditor are concerned, it must be remembered that "the responsibility for public accounts lies with the directors . . . and so long as the accounts comply with the minimum legal standard of disclosure the auditor has no official power whatever to interfere with the discretion of the board" (cf. *The Accountant*, April 16, 1932).

Mr. Littleton, further, argues from circumscription of auditors' duties by the English courts. In view of the fact that legislative prescription of those duties, beyond a generalization that they shall report whether or not the balance-sheet "is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs," whatever that may be, is conspicuously absent from the statute book, it is fair to inquire what guide-posts have emerged from litigation. A classic dictum reads: "It is the duty of an auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonably competent, careful and cautious auditor would use. What is reasonable care, skill and caution must depend upon the particular circumstances of each case. An auditor is not bound to be a detective, . . . to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watch dog, but not a bloodhound" (*Re Kingston Cotton Mill Co.*). This, it would seem, is broad enough to catch within its net a multitude of sins and yet not place impossible burdens upon the profession. (For a recent case of misfeasance which cost an auditor upwards of £8,000, see *in re Fulton & Co.*, [1932]). But perhaps the decision *in re London General Bank* is in the minds of the authors whom Mr. Littleton cites. From that case we have it that "it is no part of an auditor's duty to give advice either to directors or shareholders as to what they ought to do"; he has nothing to do with the way in which the business is carried on. While I would not like to express agreement with all the implications involved, I do think that this decision points to the essential, if sometimes forgotten, fact that the accounts of a company are the accounts of directors and that the primary responsibility for them is theirs, a responsibility, moreover, that should in no circumstances be weakened or shifted to auditors. Let us be reminded of the original meaning of the word audit: "the hearing of explanations from the person rendering the account."

The legislature has in fact always refused a detailed or "cast-iron statutory" definition of auditors' powers and duties. Despite urging from various quarters, the most recent committee on company law reform (1925–26) again declined to recommend such, holding it better that "the law should retain its elasticity in this respect than that an attempt should be made to confine it within the bounds of a rigid formula." Wisdom and experience are embodied in this view. As it was argued before the committee, "a list of duties always leaves something in the air . . . the auditor might say, 'That is not in the statute, therefore I do not propose to do it.' . . . The cases vary so enormously that what is applicable in one is not applicable in another." Or, as a president of the Institute of Chartered Accountants (H. L. H. Hill) has since observed: "I believe that the time will never come when legislation can be so definite and comprehensive that auditors will be reduced to mere automata, to obey audit programmes laid down by statute. The whole value of our work is dependent upon our proper exercise of judgment" (*The Accountant*, January 9, 1932). "In our professional life proper conduct has not been brought about and can not be brought about by legislation" (*The Accountant*, May 7, 1932). It is also of interest to mention that a committee of the board of trade on the registration of accountants refused, in 1930, to recommend such registration, in spite of the fact that the companies' acts do not require auditors of public companies to have any special qualifications. The committee found no evidence to show that any useful purpose would be served.

Mr. Littleton finds a necessity for an "American plan to fit American conditions." It strikes an American as peculiarly odd that he should overlook the admirably poised, if not altogether infallible, system of checks and balances which inheres in English audit practice, not to mention its happy characteristics of elasticity and freedom for the exercise of that judgment so necessary in the practice of public accounting. Strangely, he offers in alternative a proposal for the regimentation of the profession and practice from which, so far as I can see, anything in the nature of check and balance is conspicuously absent—a scheme fraught with danger from several points of view, not the least of which is that it would be apt to create in the minds of directors and investors "the feeling that the state is the chief mentor of the one and the guardian of the other." Under his plan, all statements submitted to the securities commission are to be certified only by licensed auditors whose tenure is subject only to a governmental board of review charged with the responsibility of their appointment and discipline, of defining their duties, and, as well, empowered to adjudicate and officially to pronounce upon controverted questions of accounting theory and practice. Such a board, it is argued, would under the afflatus of high position, plus a not inconsiderable lure of fat pensions, draw to its membership personnel of the highest calibre professionally and of utter devotion to the common weal.

In the first place, is it presumptuous to inquire what there is in the past experience of our country, or in the visible future, which would guaranty that appointments to (or under) such a commission would be free from political interference (what, then, of that independence so desirable in an auditor?), or that it would attract the best of our accounting intelligence? It would seem that there is only one answer: an emphatic "No." Next, in the case of controversy between a corporation and licensed auditors (and what possibilities thereof!), the dice seem to be loaded in favor of the latter and of the particular views of the board. In common matters of accounting policy, there is more often than not room for a legitimate and, indeed, wide diversity of opinions—any one of which could perhaps be reasonably supported. A company might be forced to accept a decision from Washington against its own best judgment and that of its accounting advisors. Can it be maintained seriously that holy writ in a matter such as obsolescence, for example, sanctified as administrative law by such a body, would necessarily be the part of wisdom? There is in accounting, peculiarly, a broad area of "scientific guesswork." It is preposterous to suppose either that the responsibility therefor can be shifted to the shoulders of civil servants or that by so doing that area can be narrowed. Nor by attempting to do so should investors be misled into thinking that it either can be or is being done. And, even in routine matters of audit, I venture to doubt whether an auditor labelled with the magic word "licensed" could attain superior results from their point of view.

No doubt under English practice when differences arise between directors and auditors, the directors may in some cases exercise considerable pressure to bring about acceptance of their views by the auditors (see, for example, *Minutes of evidence*, company law amendment committee [1926], QQ. 520; 3617–19). And, if the directors are forceful, and not wholly wrong, and the auditors are somewhat compliant, the results may be—indeed in some cases clearly have been—prejudicial to the interests of the stockholders. But this is merely to say that the system does not function perfectly; and admitting this to be a fact, it is reasonably certain that discussion between two parties, each possessing special experience and each vested with definite powers and responsibilities, will, by and large, produce better results than a bureaucratic control which in actual practice is apt to be exercised by persons of less competence, acting with less sense of personal responsibility.

May I quote in conclusion, and in illustration of what I believe to be the sound point of view in this whole matter a remark made a decade ago by Sir Josiah Stamp? It is well known that his distinction is by no means confined to his own profession. "I think," he said, "accountancy will grow more by modifying conventions than by force of law." As a recent example of this line of advance, one may mention the form of auditors' report, etc., developed as a result of coöperation between the American Institute of Accountants and the authorities of the stock exchange. It called forth the following comment from the other side of the Atlantic:

"It is interesting to reflect that this result has been achieved by coöperation between the expert interests affected, and that it has not been necessary to invoke legislative sanction. It seems natural to expect that the parties who have contributed to this happy agreement will do their utmost to secure that American business units and the American investing public shall understand the general nature of an audit and its inevitable limitations. We rather envy our American cousins, too, on the score that the coöperation which has resulted in the agreement can be used advantageously if it should later appear that some amendment is required. In that event, no such cumbersome machinery as parliamentary action need to be invoked; the parties will again confer, and if they again display the qualities of wise statesmanship which their present action has revealed, they are likely to have no difficulty in amending the result of their present labours" (*The Accountant*, May 19, 1934).

The profession in this country is under challenge to resist any attempt to have its freedom of development arrested, or its hands shackled, in the course of the overemphasis on the prerogatives of government which characterizes the hour.

Students' Department

H. P. Baumann, *Editor*

Goodwill in Consolidated Balance-sheet Problems

effect of sale of subsidiary's stock to outsiders on the parent company's interest

A correspondent, in commenting upon the discussion of goodwill in consolidated statements appearing in the *Students' Department* in the December, 1934, issue of The Journal of Accountancy, asks "suppose a corporation owned 90 per cent. of the outstanding stock of a subsidiary and it had been its practice to add its share of profits of the subsidiary to the investment account, what would be the effect on these original holdings if the subsidiary sold treasury stock to outside interests?"

On page 465 of the December, 1934, issue of The Journal, I had made the statement that "The point to be remembered here is that the value of the goodwill per share attaching to any purchase is set once and for all at the time of the purchase." I am of the opinion that subsequent sales of stock of the subsidiary to others does not affect the goodwill acquired by the parent company.

To simplify the discussion, unissued stock is used in the examples, although the method of accounting would not have been changed had treasury stock been used.

Let us assume that the S (subsidiary) Company is incorporated for $100,000 (1,000 shares of a par value of $100 per share), and immediately sells 900 shares to the P (parent) Company for $90,000; the remaining 100 shares is unissued. At this point, P Company holds a 100 per cent. interest in the outstanding stock of S Company, as shown below:

Example 1

	S Company Capital stock outstanding
Balance	$90,000
Cost of P Company's interest	90,000
Goodwill	$ 0

If the 900 shares were acquired at a price in excess of par value (say $95,000) the situation would be:

Example 2

	S Company	
	Capital stock outstanding	Premium on stock
Balances	$90,000	$5,000
Cost of P Company's interest	90,000	5,000
Goodwill	$ 0	$ 0

It will be seen from the above that P Company, as 100 per cent. owner, paid nothing for goodwill when it acquired the stock from S Company at a premium.

If (under example 1) the remaining 100 shares of stock of S Company are sold later in the day, the changes may be shown as follows:

Example 3

	S Company Capital stock outstanding
Balance	$100,000
Minority interest (10%)	10,000
P Company's interest (90%)	$ 90,000
Cost of P Company's interest	90,000
Goodwill	$ 0

It will be noted that while there has been no change in the number of shares held by P Company, its interest has decreased from 100 per cent. to 90 per cent.

But let us alter example 3 by assuming that the 100 shares were sold for $11,000 and see what effect that has on the problem.

Example 4

	S Company	
	Capital stock outstanding	Premium on stock
Balances	$100,000	$1,000
Minority interest (10%)	10,000	100
P Company's interest (90%)	$ 90,000	$ 900
Cost of P Company's interest	90,000	
Credit to surplus of P Company		900
Goodwill	$ 0	$ 0

There can be no question but that there were two separate and distinct transactions in the stock of S Company, and that they must be so considered, even though they took place on the same day. At the time of the purchase of the 900 shares of the stock by P Company, it obtained an interest equal to the entire book value of S Company. Later in the day, when the remaining 100 shares were sold at a premium of $1,000, the P Company was entitled to its share of such premium, and could properly increase its investment account by $900 with a corresponding credit to its surplus account. The minority interests were entitled to their share (10 per cent.) of the premium which they paid upon becoming stockholders.

Now let us change the problem a bit by assuming that the P Company acquired 900 shares of S Company stock from the stockholders who had just incorporated S Company (rather than from the company itself) at a cost of $95,000.

Example 5

	S Company Capital stock outstanding
Balance	$90,000
Cost of P Company's interest	95,000
Goodwill	$ 5,000

As the excess of the payment over the par value of the stock was not received by the S Company, but by outside stockholders, such excess does not increase the net worth of the subsidiary, as in example 2, but represents a payment for goodwill.

Let us further assume that in the afternoon, the S Company sold the remainder of its unissued stock (100 shares) for $12,000. What is the effect of this sale?

Example 6

	S Company	
	Capital stock outstanding	Premium on stock
Balances	$100,000	$2,000
Minority interest (10%)	10,000	200
P Company's interest (90%)	$ 90,000	$1,800
Cost of P Company's interest	95,000	
Credit to P Company's surplus		1,800
Goodwill	$ 5,000	$ 0

Again it is apparent that P Company shares proportionately in the premium received on the subsequent sale of capital stock to minority interests. Its share of the premium ($1,800) could be taken up in its accounts by a charge to investment account and a credit to surplus. The elimination for goodwill computation would be:

Cost of 900 shares of stock	$ 95,000	
Proportionate share of premium	1,800	
Total in investment account		$96,800
Book value of S Company:		
Capital stock	$100,000	
Premium on stock	2,000	
Total book value	$102,000	
90% thereof		91,800
Goodwill		$ 5,000

Conversely, if the stock were sold to the minority interests at a discount of $2,000, P Company should credit its investment account with its proportionate interest ($1,800) and charge surplus. The goodwill would remain the same, as shown below:

Cost of 900 shares of stock	$ 95,000	
Less: proportionate share of stock discount	1,800	
Total in investment account		$93,200
Book value of S Company:		
Capital stock	$100,000	
Less: stock discount	2,000	
Total book value	$ 98,000	
90% thereof		88,200
Goodwill		$5,000

From the two preceding computations, it will be seen that the goodwill determined at the date of acquisition is not affected by subsequent sales to minority interests. It would be rather difficult to sustain the position that the share in the premium ($1,800) should be applied in reduction of the goodwill, since you must at the same time justify the assertion that stock discount would increase the amount of goodwill.

In the above examples, it was assumed that the stock of S Company was sold before the company began actual operations. Let us consider a case in which P Company purchases on January 1, 1934, 900 shares of the stock of S Company from stockholders for $95,000, the profits of S Company amount to $10,000 for the year ended December 31, 1934, and, on that date, the remaining 100 shares of unissued stock is sold by S Company for par ($10,000).

Example 7

	S Company	
	Capital stock outstanding	Surplus
Balances, December 31, 1934	$100,000	$10,000
Minority interest (10%)	10,000	1,000
P Company's interest (90%)	$ 90,000	$ 9,000
Cost of P Company's interest	95,000	
Credit to P Company's surplus		9,000
Goodwill	$ 5,000	$ 0

Obviously, the minority interest is entitled to 10 per cent. of the book value at December 31, 1934, or a total of $11,000, even though the amount received for the stock sold to them is but $10,000. And, further, if $1,000 of the surplus earnings is to be shown as a credit to the minority interest, only $9,000 of such earnings may be taken up by the P Company. However, the P Company fully owned and controlled S Company during the entire period of its operations, and hence, should be permitted to take up the entire amount of the earnings of $10,000. This contention is emphasized if we assume that the unissued stock was not sold to the minority interests until the next day, January 1, 1935. At December 31, 1934, P Company would have a 100 per cent. interest in the outstanding capital stock of $90,000 and the surplus of $10,000.

Probably as good a method as any to record these facts on the books of P Company would be:

Investment in S Company		Goodwill		Surplus	
(1) $90,000	(3) $1,000	(1) $5,000		(3) $1,000	
(2) 10,000					(2) $10,000

Cash	
	(1) $95,000

(1) To record the payment of $95,000 in cash for the outstanding 900 shares of stock of S Company. In the above example, the investment has been distributed to show the underlying equity in the net assets of S Company in the "investment" account, and the goodwill element in the "goodwill" account. In practice, generally, these two accounts would be combined.

(2) To record the subsidiary profits for the year 1934.

(3) To give effect to the change in the underlying equity in the net assets of S Company arising through the sale of 100 shares of unissued stock of that company at par.

If we assume that the minority interest was purchased on January 1, 1935, and that the profits for the year 1935 amounted to $15,000 we would have at December 31, 1935, the following:

Example 8

	S Company	
	Capital stock outstanding	Surplus
Balances, January 1, 1934	$ 90,000	
Profits for 1934		$10,000
Sale of stock, January 1, 1935	10,000	
Profits for 1935		15,000
Balances, December 31, 1935	$100,000	$25,000
Minority interest (10%)	10,000	2,500
P Company's interest (90%)	$ 90,000	$22,500
Cost of P Company's interest	95,000	
Goodwill	$ 5,000	

The transactions of example 8 may be shown on the books of P Company as follows:

Investment in S Company		Goodwill		Surplus	
(1) $90,000	(3) $1,000	(1) $5,000		(3) $1,000	(2) $10,000
(2) 10,000					(4) 13,500
(4) 13,500					

Cash	
	(1) $95,000

(1) To record the payment of $95,000 in cash for the 900 shares of stock of S Company on January 1, 1934.

(2) To record the profits (100%) of S Company for the year 1934.

(3) To give effect to the change in the underlying equity in the net assets of S Company arising through the sale of 100 shares of unissued stock, at par, on January 1, 1935.

(4) To record the proportionate interest (90%) in the profits of S Company for the year 1935 (90% of $15,000).

Now let us change the problem appearing on page 468 of the December, 1934, issue of THE JOURNAL OF ACCOUNTANCY and assume the following:

Problem:

The S Company's balance-sheet at December 31, 1933, contained the following accounts:

Capital stock authorized (2,000 shares)	$200,000
Unissued stock (300 shares)	30,000
Treasury stock (50 shares) at cost	7,500
Surplus	20,000
Capital surplus (arising from appraiser's revaluation of fixed assets)	4,500
Premium on stock (issued at 110)	17,000
Reserve for sinking fund	35,320
Reserve for extension of plant	20,000

On December 31, 1933, the P Company purchases 90 per cent. of the outstanding stock of S Company at $170 per share. During the year 1934, the S Company had earnings of $15,000 and the P Company took up its proportion of such earnings (90 per cent. of $15,000 or $13,500) by a charge to its investment account in the stock of S Company and a credit to its surplus account. The surplus account of S Company showed a balance of $35,000 at December 31, 1934. On this latter date, the 50 shares of treasury stock of S Company were sold to outsiders for $7,500. Compute for consolidated balance-sheet purposes, the goodwill arising from the transactions, and give a transcript of the ledger accounts of P Company.

Solution:

Net worth of S Company December 31, 1933:

Capital stock (authorized)		$200,000	
Less:			
Unissued stock	$30,000		
Treasury stock (par)	5,000	35,000	
Capital stock outstanding			$165,000

Surplus and surplus appropriations:		
Surplus	$ 20,000	
Capital surplus	4,500	
Premium on stock (original issue)	17,000	
Reserve for sinking fund	35,320	
Reserve for extension of plant	20,000	
Total	$ 96,820	
Less: premium on treasury stock	2,500	
Total surplus and surplus appropriations		$ 94,320
Total book value of 1,650 shares outstanding		$259,320

The computation of goodwill is a simple matter:

Net worth of S Company at December 31, 1933	$259,320
Minority interest (10%)	25,932
P Company's interest (90%)	$233,388
Cost of P Company's interest—1,485 shares (90% of 1,650) at $170 per share	252,450
Goodwill	$ 19,062

As we learned above, the amount of the goodwill was set at the time the stock in S Company was acquired. But what is the effect of selling the treasury stock of S Company, one year later, after the company had earned a profit of $15,000? This stock was sold at cost; hence, the book value of S Company, at December 31, 1934, would be:

Book value, December 31, 1933 (per above)	$259,320
Profits for the year 1934	15,000
Total	$274,320
Treasury stock sold:	
Par value of additional stock outstanding	5,000
Premium	2,500
Book value, December 31, 1934	$281,820

The 90 per cent. interest of P Company has been "diluted," because of the sale of the treasury stock, to 87.35 + per cent. The underlying equities in the net assets of S Company at December 31, 1934, are therefore:

P Company (1,485/1,700)	$246,178
Minority interest, including the treasury stock purchasers, (215/1,700)	35,642
Total	$281,820

The accounts of P Company would show:

Investment in S Company		Goodwill		Surplus	
(1) $233,388	(3) $710	(1) $19,062	(3) $710		
(2) 13,500					(2) $13,500

Cash	
	(1) $252,450

(1) To record the payment of $252,450 for 1,485 shares of stock of S Company at December 31, 1933, representing:

Underlying equity in net assets	$233,388
Goodwill	19,062
Cash	$252,450

(2) To record 90% of the profit of $15,000 earned during 1934.

(3) To adjust the investment account to agree with the change in the equity in the net assets of S Company at December 31, 1934.

The purchasers of the 50 shares of treasury stock acquired an equity in the S Company of (50/1,700 of $281,-

820), or	$ 8,289
for which they paid	7,500
and received an excess of equity over cost of	$ 789

This excess should be apportioned as follows:

P Company (1,485/1,650)	$ 710
Minority interest at December 31, 1933 (165/1,650)	79
Total	$ 789

American Institute Examination

This department has received two letters expressing disagreement with the solution to problem 1, part II, of the November, 1934, examination. The solution appeared in the *Students' Department* for March, 1935. The problem is given below:

On December 31, 1928, the Star Drug Company with an outstanding capital of $500,000, the Mormon Drug Company with an outstanding capital of $400,000 and the Gulf Drug Company with an outstanding capital of $450,000 —all shares of $100 each—merged into one operating company known as Continental, Inc., with a capital stock issue of 1,350,000 shares of no par value.

The stockholders of the three merging companies received the 1,350,000 shares in return for their aggregate holdings of $1,350,000 par, i. e., 100 shares of Continental, Inc., for each share of the merging companies. On the above date Continental, Inc., also took over all the assets and liabilities of the three companies. Their individual charters were, however, kept alive.

On December 31, 1933, five years later, the balance-sheet of Continental, Inc., was:

Assets

Cash		$ 150,000
Accounts receivable:		
Star Drug Co. customers	$ 125,000	
Mormon Drug Co. customers	100,000	
Gulf Drug Co. customers	70,000	295,000
Inventory:		
Star Drug Co. products, materials, etc.	$ 140,000	
Mormon Drug Co. products, materials, etc.	120,000	
Gulf Drug Co. products, materials, etc.	115,000	375,000
Plant and equipment at present values appraised on December 31, 1933:		
Star Drug Co. plant	$1,500,000	
Mormon Drug Co. plant	1,300,000	
Gulf Drug Co. plant	1,000,000	3,800,000
		$4,620,000

Liabilities

Accounts payable		$ 89,000
Bonds of subsidiary companies:		
Star Drug Company	$1,197,400	
Mormon Drug Company	783,160	
Gulf Drug Company	519,440	2,500,000
Capital stock outstanding		785,000
Surplus		1,246,000
		$4,620,000

At December 31, 1933, Continental, Inc.'s, stockholders decided to decentralize and restore to each of the original companies its proportion of assets and liabilities. The net worth was to be prorated on the basis of each company's capital investment on December 31, 1928, and it was found that the Star Drug Company was to receive 40%, the Mormon Drug Company 36% and the Gulf Drug Company 24%.

On December 31, 1928, the three merging companies owned each other's stock as follows:

The Star Drug Company owned:	
1,200 shares Mormon Drug Co., cost	$ 100,000
2,500 shares Gulf Drug Co., cost	200,000
The Mormon Drug Company owned:	
1,000 shares Gulf Drug Co., cost	75,000
500 shares Star Drug Co., cost	50,000
The Gulf Drug Company owned:	
50 shares Mormon Drug Co., cost	10,000
400 shares Star Drug Co., cost	30,000

A summary of Continental, Inc.'s surplus shows:

Surplus of merging companies—December 31, 1928:	
Star Drug Company	190,000
Mormon Drug Company	375,000
Gulf Drug Company	81,000
Excess of par over book value of intercompany holdings	100,000
Earnings of five years	892,500
	$1,638,500
Less: dividends paid	392,500
Balance, December 31, 1933	$1,246,000

It was decided that in the redistribution each of the three companies would receive a proportionate share of the cash; its own accounts receivable and inventory; its original investments in the other companies at original cost to itself and its own plant and equipment. On the other hand, each would assume a proportionate share of the current liabilities but would become wholly liable for its own outstanding bonds. All differences were to be charged or credited to current account for future settlement.

From the foregoing data prepare:

1. A statement showing in columnar form the balance-sheets of the three drug companies after decentralization on December 31, 1933.
2. A statement showing that the adopted ratio 40: 36: 24 approximately agrees with the proportions existing on December 31, 1928.

The point of disagreement may be stated as follows: In connection with the distribution of the assets and liabilities of Continental, Inc. in the ratio of 40, 36, and 24, should the intercompany stockholdings be valued:

(1) At the original cost to the three predecessor companies, or

(2) At an adjusted value based upon the value of the net assets underlying the stocks.

In the published solution, the stocks were valued on the first basis; my correspondents believe that the second basis should have been used.

The problem states: "It was decided that in the redistribution each of the three companies would receive ...., its original investments in the other companies at original cost to itself ...." This seems to be a clear and definite statement. However, the result is inequitable because the three old companies are not left in their original relative positions with respect to each other.

It seems, therefore, that anyone solving this problem is confronted by the following dilemma: If he uses the first basis of valuation of the stocks, he complies with the requirements of the problem but an equitable redistribution is not effected; if he applies the second basis of valuation, he produces an equitable redistribution but does not comply with the requirements of the problem.

Faced with such a dilemma, a candidate should probably be governed by the express wording of the problem, and the published solution was prepared on that basis. For the benefit of any who may be interested, a solution on the other basis is submitted below:

(1) Several methods may be used in ascertaining the book values of the intercompany stockholdings at December 31, 1933. The following is quite simple:

The intercompany holdings may be listed as follows:

	Star		Mormon		Gulf	
	Shares	Fraction	Shares	Fraction	Shares	Fraction
Star Drug Company..			1,200	3/10	2,500	5/9
Mormon Drug Company............	500	1/10			1,000	2/9
Gulf Drug Company..	400	2/25	50	1/80		
"Outside" stockholders	4,100	41/50	2,750	11/16	1,000	2/9
Totals..........	5,000	50/50	4,000	80/80	4,500	9/9

The adjusted net worth of the three companies, after considering the intercompany stockholdings at book value, may be ascertained as follows:

Let x = the adjusted net worth of the three companies.

$41/50(.40x)$, or $.328x$	= the net assets of the Star Drug Company in the hands of outsiders.
$11/16(.36x)$, or $.2475x$	= the net assets of the Mormon Drug Company in the hands of outsiders.
$2/9\ (.24x)$, or $.0533\frac{1}{3}x$	= the net assets of the Gulf Drug Company in the hands of outsiders.

Then	$.6288\frac{1}{3}x$	= $2,031,000, the net worth of Continental, Inc.
or,	x	= $3,229,791, the total adjusted net worth of the three companies.

This total adjusted net worth is distributed below:

	Adopted ratio	Amount
Star Drug Company	40%	$1,291,916
Mormon Drug Company	36	1,162,725
Gulf Drug Company	24	775,150
Totals	100%	$3,229,791

As these adjusted net worth figures include the intercompany stockholdings at book value, and, further, as these stockholdings are to be distributed on a basis of original cost, it will be necessary to make a further adjustment before the balance-sheets after decentralization at December 31, 1933, may be set up.

	Star Drug Company	Mormon Drug Company	Gulf Drug Company
Adjusted net worth (per above)	$1,291,916	$1,162,725	$775,150
Deduct book values of intercompany stockholdings:			
Star Drug Company:			
1/10 of $1,291,916		$ 129,192	
2/25 of $1,291,916			$103,353
Mormon Drug Company:			
3/10 of $1,162,725	$ 348,817		
1/80 of $1,162,725			14,534
Gulf Drug Company:			
5/9 of $775,150	430,639		
2/9 of $775,150		172,256	
Total deductions	$ 779,456	$ 301,448	$117,887
Total net worth before intercompany stockholdings	$ 512,460	$ 861,277	$657,263

Add:			
Intercompany stockholdings, at original cost:			
Star Drug Company		$ 50,000	$ 30,000
Mormon Drug Company	$ 100,000		10,000
Gulf Drug Company	200,000	75,000	
Total intercompany stockholdings, at cost	$ 300,000	$ 125,000	$ 40,000
Total net worth including intercompany stockholdings, at cost	$ 812,460	$ 986,277	$697,263
Divided as follows:			
Capital stock	$ 500,000	$ 400,000	$450,000
Surplus	312,460	586,277	247,263
Total	$ 812,460	$ 986,277	$697,263

The following is the statement showing in columnar form the balance-sheets of the three drug companies after decentralization on December 31, 1933. The differences after the redistribution as required by the problem are charged or credited to current account for future settlement:

Assets	Star Drug Company	Mormon Drug Company	Gulf Drug Company
Current assets:			
Cash	$ 60,000	$ 54,000	$ 36,000
Accounts receivable	125,000	100,000	70,000
Inventories	140,000	120,000	115,000
Total current assets	$ 325,000	$ 274,000	$ 221,000
Due from Star Drug Company	$	$ 22,937	$
Due from Gulf Drug Company	$	$ 79,540	$
Plant and equipment	$1,500,000	$1,300,000	$1,000,000
Investments (at cost):			
Star Drug Company	$	$ 50,000	$ 30,000
Mormon Drug Company	100,000		10,000
Gulf Drug Company	200,000	75,000	
Total investments	$ 300,000	$ 125,000	$ 40,000
Total assets	$ 2,125,000	$1,801,477	$1,261,000

Liabilities and net worth			
Accounts payable	$ 35,600	$ 32,040	$ 21,360
Due to Mormon Drug Company	79,540		22,937
Bonds outstanding	1,197,400	783,160	519,440
Total liabilities	$1,312,540	$ 815,200	$ 563,737
Net worth:			
Capital stock	$ 500,000	$ 400,000	$ 450,000
Surplus	312,460	586,277	247,263
Total net worth	$ 812,460	$ 986,277	$ 697,263
Total liabilities and net worth	$2,125,000	$1,801,477	$1,261,000

The solution under requirement (2) is not affected and will be the same as that appearing on pages 232 to 234 of the March, 1935, issue of THE JOURNAL OF ACCOUNTANCY.

Accounting Questions

[The questions and answers which appear in this section of THE JOURNAL OF ACCOUNTANCY have been received from the bureau of information conducted by the American Institute of Accountants. The questions have been asked and answered by members of the American Institute of Accountants who are practising accountants and are published here for general information. The executive committee of the American Institute of Accountants, in authorizing the publication of this matter, distinctly disclaims any responsibility for the views expressed. The answers given by those who reply are purely personal opinions. They are not in any sense an expression of the Institute nor of any committee of the Institute, but they are of value because they indicate the opinions held by competent members of the profession. The fact that many differences of opinion are expressed indicates the personal nature of the answers. The questions and answers selected for publication are those believed to be of general interest.—EDITOR.]

DISTRIBUTION OF OVERHEAD IN BAKERY

Question: Would you kindly advise me what methods are used in the distribution of overhead expenses in a bakery having the following departments: bread, cake, pastry and doughnut?

The direct labor allocable to each of the above departments is clearly earmarked, but the overhead expenses, such as depreciation on buildings and equipment, taxes, insurance, indirect labor, etc., overlap to a great extent.

The direct labor basis of distribution does not seem equitable for the reason that the pastry and cake departments have more hand work and less machine work than the bread department. The other possible bases would be retail sales value, production tonnage or prime cost (material and labor combined); but none of these bases appears to give a fair distribution.

I would be interested to know what basis is commonly used by the larger bakery companies which produce the above four kinds of bakery products.

Answer No. 1: The distribution of the overhead expenses as between products presents a difficult problem and in the consideration of any method of distribution the arbitrary features of the apportionment of the expenses must be recognized. We have found that certain prominent baking companies do not distribute the overhead expenses as between products; the departmental statement of operations reflects only the direct charges to the departments.

The following is suggested as a method of distribution of these expenses:

Indirect labor— (superintendence, etc.)	On basis of sales value of product
Depreciation, taxes, rent, plant general repairs, etc.	On basis of floor space
Salesmen's salaries	Generally paid on commission basis which may be charged direct. Other payments on basis of sales value
Advertising, etc.	On basis of sales value
Truck expense— (gasoline, repairs, depreciation, etc.)	On basis of tonnage
Administrative expenses	On basis of sales value

VALUATION OF STOCK-EXCHANGE SEAT

Question: In the case of the audit of a stock-exchange member firm, a seat is carried on its books for an amount considerably above the market price (last sale) at the close of its fiscal year.

Should a write-down (direct or reserve) from the cost to market price be made?

Answer No. 1: A stock-exchange seat is somewhat in the nature of a fixed asset which can not be disposed of if the firm is to continue in business, and temporary fluctuations in the market prices of such seats should not necessarily be reflected in the earnings or the capital of the firm. However, as a matter of conservatism some firms do write down the values at which stock-exchange seats are carried to market values, or even below.

As a practical matter, such write-downs have no real effect, at least from the standpoint of financial statements prepared for the stock exchange or for other financial interests, for the reason that in determining the working capital position of a firm, it is the invariable custom to deduct from the firm's total capital the value at which the exchange seats are carried on its books. This is for the reason that such seats have no value as collateral, due to the restrictions upon their sale and the fact that the other members of the exchange, in case of trouble, have a first lien upon the proceeds realized from their sale.

Summing up, therefore, it is not in our opinion essential that the value of such seats be written down to market value, but, in case of any wide variance therefrom, the best practice would seem to require that a footnote to that effect be placed on the balance-sheet or that the market value as of the date of the balance-sheet be inserted parenthetically.

Answer No. 2: It is not customary to write down or write up the cost to last sale value unless there be a dissolution of the firm by reason of either retirement or admission of partners. In other cases, it is regarded as good accounting procedure for the auditor to indicate the current market value of seats through the medium of parenthetic reference on the balance-sheet so that the information might be made available to those receiving copies of the financial statement.

Some contracts of partnership provide for periodic adjustments in such values for the purpose of fixing a more equitable basis upon which to calculate interest allowance to the partner contributing the use of his membership.

The majority of such contracts are silent on the subject of revaluation. In such circumstances, the accountant is without authority to make any adjustments—hence the thought of recording the market value through the bracketed reference on the balance-sheet.

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